

REGIONAL CREDIT ASSESSMENT PROJECT IN AZERBAIJAN

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United States Agency for International Development (USAID)

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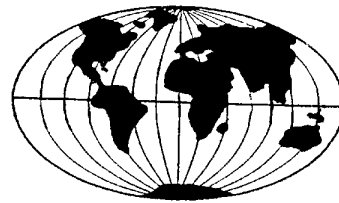
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EXECUTIVE SUMMARY

1. OBJECTIVE

This report presents the results of the Regional Credit Assessment Project in Azerbaijan conducted from August 10 - 29, 2001 under the Caucasus Regional Credit Evaluation Project, IQC Contract No. AEP-1-00-00-00023-00, Work Order #808. The purpose of the project was to review, analyze and assess the status of development of the finance sector including financial products and credit provided by formal banks and non-bank financial institutions (NBFIs) targeted on microlending and small and medium size enterprises (SME). Based on the findings, the team made strategic and programmatic recommendations for USAID's ongoing assistance.

The assessment team was tasked by USAID to assess the following major issues having to do with MSME finance:

- Issue 1: Major constraints to access to credit;*
- Issue 2: Demand for and supply of credit and related products and services;*
- Issue 3: Demand for new and expansion of existing products;*
- Issue 4: Strengths, weaknesses, opportunities and threats relating to USAID funded credit institutions;*
- Issue 5: Prospects for the sustainability of microfinance institutions; and,*
- Issue 6: Transition from humanitarian relief to enterprise development credit.*

A total of eight (8) USAID-funded organizations were visited in the capital, Baku, and the central and southern regions of the country. The team met with twenty-three (23) key people in these organizations to discuss their programs. A study guide was used in our interviews to assure consistency in the data being collected. The USAID-funded organizations contacted were:

➤ **Mercy Corps International (the umbrella for several of USAID's microfinance projects)**

Four of the implementing NGOs interviewed commenced their activities with a principally humanitarian focus and are assigned to S.O.3.1: Reduced Human Suffering in Conflict-Affected Areas:

- Adventist Development and Relief Agency (ADRA);
- International Rescue Committee (IRC);
- Save the Children Federation (SCF); and
- World Vision.

Three of the implementing NGOs are assigned to S.O.1.3: Accelerated Development and Growth of Private Small and Medium Enterprises in Targeted Areas:

- ACDI/VOCA;
- Shorebank Overseas Azerbaijan; and
- FINCA

In addition to the implementing NGOs, the team also contacted Azerbaijani formal banking institutions to expand the breadth and depth of our understanding of the kinds of financial products offered, their availability in the country, and generally how banks do business. The following six banking institutions were included in the assessment.

- The Bank's Association;
- The Bank of Baku;
- The International Bank of Azerbaijan;
- PromTekhBank;
- Rabitabank; and
- AzeriGazBank

Twelve individuals representing the banks and the Bank's Association participated in the assessment through personal interviews or by completing the institutional questionnaire that was sent out to both formal bank and non-bank institutions.

II. PRINCIPAL FINDINGS

A. EVOLUTION OF USAID-FINANCED CREDIT FUNDS

The NGO community started their microcredit projects as extensions of their Humanitarian Assistance Programs. They initially targeted the thousands of Internally Displaced People (IDPs) who became refugees in their own country stemming from the Nagorno-Karabakh conflict. Over the years, thousands of fledgling entrepreneurs in Azerbaijan, both from IDP and regular local communities, have received credit assistance for their enterprises through these projects. These NGO microcredit projects are the only source of finance for most owners and operators of microenterprises.

Despite serious start-up problems in some cases, NGOs are currently carrying out their projects quite effectively. Their managements have a high degree of understanding, at least in the USAID-financed NGOs, of financial and methodological best practices. The projects are reaching a general universe of individuals (with specific attention to women), who lack access to credit and, from data currently available, have proven to have been able to use the resources reasonably well as reflected by loan repayment rates in the high 90% range.

B. STRATEGIC COMPLEMENTARITY BETWEEN S.O.1.3 AND S.O.3.1

USAID's Strategic Plan delineates two Strategic Objectives that include microcredit and SME lending activities. S.O.1.3: Accelerated Development and Growth of Private Small and Medium Enterprises in Targeted Areas has three credit projects. ACDI/VOCA focuses on small scale agricultural enterprises, Shorebank Overseas Azerbaijan focuses on larger small and medium scale businesses, and FINCA works with microenterprises. S.O.3.1: Reduced Human Suffering in Conflict-Affected Areas has four microcredit projects. They are the Adventist Development and Relief Agency (ADRA), the International Rescue Committee (IRC), Save the Children Federation (SCF), and World Vision.

Most microcredit activity is currently carried out under the S.O.3.1 humanitarian objective with one microcredit project housed in S.O.1.3. Microcredit in both S.O. areas essentially reach the

same kinds of enterprises and follow the same underpinning methodological precepts, including varying levels of implementation of microfinance best practices that set the basis for achieving loan fund sustainability over time. Microfinance project objectives, in both S.O.s, are also similar in that they focus on generating income at the most basic level of the family unit to assist with survival and generate small amounts of savings and investment. They aspire to saving and/or creating jobs for individual microenterprise owners and family members, and they all increase access to credit for a very large universe of the population that would otherwise be completely bypassed by the formal financial system.

As microcredit clients of the S.O.3.1 projects moved into second and third lending cycles, it became increasingly clear to USAID practitioners that demand existed for larger, longer-term loans. As their original clients' credit needs grew and other, larger businesses began to approach their projects, the original humanitarian based projects began to feel the need to add new financial products and lending methodologies to their programs. These new loan products assist with increased financing of productive assets and reflect the business development and growth objectives of entrepreneurs.

Microfinance projects provide a training ground and starting point for small-scale borrowers who would be probable future clients of the S.O.1.3 projects that work with larger, more growth-oriented businesses. For this reason, the Team believes that there is good synergy and strategic complementarity between the two sets of credit projects, e.g., microcredit and SME finance, even though they are, with the exception of FINCA, under the wings of the two different S.O.s.

C. SUSTAINABILITY OF LOAN FUNDS

Sustainability was not the initial priority of humanitarian NGOs working with IDPs. The projects did not have sufficient loan funds to scale-up rapidly. However, as projects have matured, most have made a concerted effort to implement sustainability enhancing best practices in their projects from in-the-field methodologies to accounting systems that reflect operating costs and fund status data. USAID's S.O.1.3 credit portfolio seems to have been established with the intent of achieving loan fund viability, but it continues to be underfunded. The projects encompassed under this S.O. were funded with more loan capital and support for technical assistance than those with a more "humanitarian" focus.

D. CONSTRAINTS TO CREDIT ACCESS

As microcredit projects grew and expanded their coverage in the business community, they became more visible within the overall context of financial sector activity in the country. With growth, visibility, and success in reaching people with financial products that filled a real need, actual and potential constraints to credit access began to be observed.

Legal and regulatory climate

Many constraints identified are closely related to a legal and regulatory climate not yet conducive to a market economy, private business approach. They are the kinds of constraints that make it difficult, risky, and costly for credit institutions and their clients to do business. Constraints were identified in areas such as the licensing of Non-Bank Financial Institutions (NBFIs) and clear legislation regarding their tax status. Another constraint on credit institutions

resulting in lack of access to credit is the void of enabling legislation, such as deposit insurance, that provide incentives for domestic savings and capital accumulation for business credit funding. Lack of standardized, transparent, across the board treatment of private property as collateral is also a strong disincentive to the development of private larger scale credit operations.

Particularly troublesome to USAID is Section 907 of the Freedom Support Act which prohibits the agency from providing direct assistance to the Government of Azerbaijan. This limits how much the agency can do to deal with these types of legal and regulatory constraints.

Long-term access to funds for financing MSME credit

International: All funds for MSME lending come from international sources. During field visits the need for uninterrupted on-going funding at higher levels and for a longer program period were brought up by international NGO implementing institutions as significant issues regarding achieving sustainability. Most of the contracts with NGOs expire in less than two years, which may jeopardize efforts to attain sustainability and, as a consequence, their ability to continue to fund loans to MSMEs.

Domestic: Without these projects, there would be literally no internal financing for MSME projects with the current situation of the national banking system. In the wake of over 200 bank closures in the past several years and the substantial lack of confidence in the banking system, local savings deposits in banks are very unlikely to develop soon, in order to become an adequate source of local MSME funding.

Need for Loan Funds: There is very high, unmet demand for funds ranging from very tiny microloans of US\$100 to US\$1,000 to loans in amounts of about US\$30,000. Local formal banking institutions are not filling this void and international donors are just scratching the surface. Without the availability of business loans, both the subsistence and market economy development objectives of USAID projects are jeopardized.

III. PRINCIPAL RECOMMENDATIONS

The recommendations listed below summarize the team's principal recommendations regarding future USAID programming for MSME:

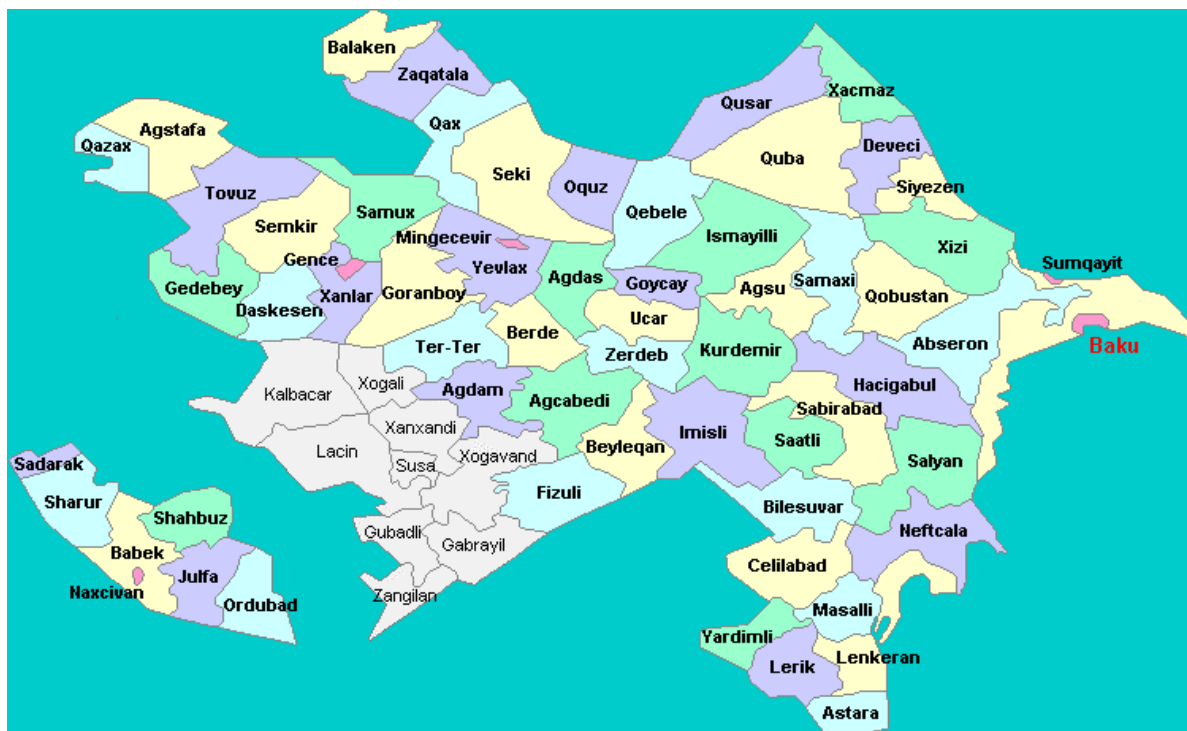
- USAID should adopt, fund, and implement expanded business loan programs for use by selected NGOs and privately-owned commercial banks. It should concentrate in the short-term on expanding funding of microloans and individual small business loans in the US\$1,000 to US\$10,000 range. Selection of organizations to receive augmented financial assistance should be done on the basis of an evaluation of their potential for short to mid-range financial or operational sustainability.
- USAID should take a lead role in causing each lending institution to do longer-term strategic planning that includes sustainability plans. USAID should require all implementing organizations to calculate capitalization requirements for sustainability in their funding requests.

- USAID should encourage legislation adopting savings deposit insurance to assist formal banks in generating internal deposits in the formal financial system. It should also encourage microfinance projects to implement or continue internal savings initiatives as described elsewhere in the body of this report.
- USAID should continue to assign microenterprise projects working primarily with IDPs, having underlying social and humanitarian objectives, under S.O.3.1. Those projects with loans for MSMEs with a clear operational bent toward economic growth and sustainability goals, should continue under S.O.1.3. Also, new projects having clearly enterprise and economic growth objectives should be assigned under S.O.1.3. Furthermore, any new, growth-oriented financial products should be developed under the aegis of S.O.1.3.
- USAID should work with its local and international private sector collaborators as well as the multilateral and bilateral donor community to encourage the Government of Azerbaijan to adopt a flat, nominal fee notary system (such as has been implemented for agricultural loans), as well as other legal and regulatory clarifications, such as in the area of licensing and taxation of NBFIs.

Finally, the Team can confirm that the entrepreneurial spirit is alive and well throughout Azerbaijan and with the availability of only a minimum of resources. However, to help achieve a firm basis of market orientation among small and medium scale enterprises, additional basic, practical business training is needed at the level of individual enterprises in addition to the financial intermediaries.

Azerbaijan

Map showing the geographical location of Azerbaijan, bordered by Georgia, Russia, Armenia, and Iran. The Caspian Sea is to the east. Major cities and regions are labeled, including Baku, Ganca, Yevlax, Naxçıvan, and the Caucasus Mountains. The map also shows the Aras River, Lake Sevan, and the Abşeron Peninsula. A scale bar indicates distances in miles and kilometers.



REGIONAL CREDIT ASSESSMENT PROJECT IN AZERBAIJAN

CHAPTER I: INTRODUCTION

A. PURPOSE OF THIS REPORT

This report presents the results of the assessment of the finance sector environment in Azerbaijan conducted from August 10 - 29, 2001. It represents the continuation of the work commenced by Development Associates, Inc. in Georgia under the Caucasus Regional Credit Evaluation Project under IQC Contract No. AEP-1-00-00-00023-00, Work Order #808. The purpose of the project in both countries was to review, analyze and assess the status of development of the financial sector. This includes financial products and credit provided by banking and non-banking financial institutions (NBFIs), primarily those targeted on microlending and small and medium size enterprises (SME). Based on the findings, the evaluation team was to make strategic and programmatic recommendations for USAID's ongoing assistance.

More specifically, the assessment team was tasked by USAID to assess the following major issues:

- Issue 1: Major constraints to access to credit;*
- Issue 2: Demand for and supply of credit and related products and services;*
- Issue 3: Demand for new and expansion of existing products;*
- Issue 4: Strengths, weaknesses, opportunities and threats relating to USAID-funded credit institutions;*
- Issue 5: Prospects for the sustainability of microfinance institutions; and,*
- Issue 6: The transition from humanitarian relief to enterprise development credit.*

A discussion of each of these issues is presented in Chapter III.

B. METHODOLOGY AND APPROACH

The Azerbaijan phase of the Project was conducted during the period August 10 through August 29, 2001. The team consisted of three members; two business and development finance experts: Marshall Burkes, Team Leader, and Ronald Bielen, and Peter Fraser, an NGO microfinance development specialist. The team conducted the assessment using document reviews and individual and group interviews at the level of borrowers and NGO microfinance service providers as it's principal information collection methods. A general meeting of USAID current and potential partners was also organized and brought together in a participatory session designed to foster dialogue between financial sector actors that infrequently shared ideas and concerns together in a professional forum.

The team's initial task was to seek out and review USAID and NGO literature in order to gain an understanding of the specific projects of USAID's partners in Azerbaijan and the financial sector generally. The team was particularly cognizant of the shift, or evolution, of USAID's credit interventions from a primarily humanitarian response focus to one that was much more developmental in nature. In this respect, they met with USAID staff responsible for the

Azerbaijan Private Sector (S.O. 1.3) and Humanitarian Response (S.O. 3.1) activities. Initial meetings with USAID personnel enabled the team to gain insights and perceptions about the sector, and provided needed guidance on key individuals and institutions to contact.

Based on these initial steps, a work plan was developed. The plan included:

- Adjusting the Georgia institutional questionnaire to adapt it to Azerbaijan.
- Distribution of questionnaires to key individuals identified by USAID.
- Personal interviews with recommended personnel from intermediary finance organizations and other institutions related to the business, legal and regulatory environment.
- Site visits to geographic areas¹ to obtain a realistic view from the field of the institutions and their borrowers.
- Interviews with two or more borrowers from each of USAID's partners and, where possible, other institutions outside the USAID sphere.
- A participatory session with key individuals.

Consistent with the work plan, after meeting with the USAID Mission personnel responsible for the credit interventions under S.O.3.1 (Humanitarian Assistance) and S.O. 1.3 (Private Enterprise Development), the team set up an initial meeting with management and staff of Mercy Corps International (MCI). It was particularly important to meet with MCI, given its role as overall manager of the umbrella Azerbaijan Humanitarian Assistance Program (AHAP) project for USAID Azerbaijan. AHAP has funded a number of the microfinance projects in country. Again, as with Mission personnel, the team was given valuable pointers to help identify the key personnel and projects to visit. Mercy Corps offered and provided their full cooperation including hosting the group participatory session with USAID partners and other important Azerbaijan formal financial sector players.

In all cases where possible, the team met first in Baku with the Directors of USAID's partner organizations. Interviews also included all heads of the institutions' credit units at the national level in Baku. These respondents provided valuable insight into the context of the financial environment encountered in terms of the policy and regulatory framework within which institutions were required to function. They were also forthright about problems encountered in project start-up and implementation. The interviews in Baku, were also an essential part for team preparations for the field trips conducted in the south in Jalilabad, the Central Region, and the Autonomous Region of Nakchivan.

A total of seven USAID-funded organizations under both S.O.s 1.3 and 3.1 were visited in Baku and the Regions. The team met with twenty-three (23) key people in these organizations to discuss their programs and followed a study guide to assure consistency in the data being collected. The organizations contacted are as follows:

¹ Baku, the Central Region (Barda/Adgam), Jalilabad in the south, and the Autonomous Republic of Nakhchivan in the southwest

➤ **Mercy Corps International (The Umbrella For Several of USAID's Microfinance Projects)**

Those working under S.O.3.1: Reduced Human Suffering in Conflict-Affected Areas:

- Adventist Development and Relief Agency (ADRA);
- International Rescue Committee (IRC);
- Save the Children Federation (SCF); and,
- World Vision.

Those working under S.O.1.3: Accelerated Development and Growth of Private Small and Medium Enterprises in Targeted Areas (only the first is under the umbrella):

- ACDI/VOCA;
- Shorebank Overseas Azerbaijan; and,
- FINCA

One non-USAID-funded NGO (interviewed in Barda)

➤ **Oxfam UK**

The team also put emphasis on contacting and obtaining information from Azerbaijani formal banking institutions to expand the breadth and depth of its understanding of the kinds of financial products offered, their availability in the country, and generally how banks do business. The following six institutions were included in our assessment.

- The Bank's Association;
- The Bank of Baku;
- The International Bank of Azerbaijan;
- PromTekhBank;
- Rabitabank; and,
- AzeriGazBank

Twelve individuals representing the banks and the Bank's Association participated in the assessment through personal interviews or by completing the institutional questionnaire that was sent out to both formal and non-bank institutions.

Overall, a total of some 35 interviews were conducted with USAID and non-USAID financial sector players in Baku, the Central and Southern Regions, and the Autonomous Republic of Nakchivan. Additionally, the team made a point of interviewing borrowers representing different programs and sizes of enterprise. A total of 24 borrower interviews were conducted by the team in Azerbaijan. The quantity of first hand, primary information collected is substantial as well as the quality of the meaningful comments.

In addition to the field interviews, completed questionnaires were received and included in the analysis. The questionnaire was designed to elicit responses from key individuals and

organizations identified by the Mission with respect to each of the issue areas identified in the SOW.

The team used the results of the questionnaires and individual interviews, along with the review of documents, reports and other existing literature, in preparing this report. Lists of person's interviewed/visited, the reports and publications reviewed, and a copy of the questionnaire is provided in the Appendices.

Upon completion of the fieldwork, the team conducted two formal debriefing sessions. The first was for Mr. William McKinney, USAID Country Coordinator and his staff. The second as arranged by Mr. McKinney, was for the Honorable Ross Wilson, Ambassador of the United States to Azerbaijan, the DCM, and the Commercial Attaché. The commentary from various participants at both meetings indicated satisfaction with the information shared in the debriefings.

CHAPTER II. THE FINANCIAL ENVIRONMENT AND CREDIT OPERATIONS

A. OVERVIEW OF THE ENVIRONMENT

Azerbaijan is a relatively small country in Southwestern Asia bordered by Iran to the South, Russia to the North, Georgia to the Northwest, Armenia to the West, and the Caspian Sea to the East. Its population numbers 8.1 million people of whom 1.8 million reside in the capital city of Baku, situated on the Western Shore of the Caspian Sea on the Abseron Peninsula.

The country regained independence from the Soviet Union in 1991 upon the collapse of the U.S.S.R. Despite its small size (about the size of the State of Maine in the U.S.), during Soviet times it was a principal supplier to the Soviet Union of fossil fuels (20%), oil exploration and extraction equipment (70%), cotton (80%), and fresh fruits (30%). These products represented 75% of the Azerbaijan's economic activity.² There were many manufacturing plants located in Azerbaijan, such as the silk factory in the City of Sheki (Saki) (a caravan stop on the famous Silk Road) that produced manufactured goods for the rest of the Soviet Union. The landscape is littered with defunct State Farms, unutilized irrigation systems, and empty buildings that once employed thousands.

As was the case with many of the other former Soviet Republics, with the dissolution of the Soviet Union, Azerbaijan had to contend with the serious economic difficulties and dislocations caused by the lack of assured markets, lack of continued subsidies for its state-owned manufacturing and agricultural enterprises, and other distortions created under the former command economic system. After 1990, the economy came to a near collapse, due to lack of continued demand from the Soviet Union. Many of the larger enterprises folded, or were reduced to a fraction of their output, resulting in large numbers of unemployed people and a very difficult situation for people who had never had to face, under the old system, this kind of structural unemployment and, often, destitution.

To add to these serious economic problems and the resulting unemployment of the people of Azerbaijan, during the early 1990s the ethnic problem over the Nagorno-Karabakh area flared up. A cease-fire was declared in 1994, but to date a peace accord has been elusive. The result of the conflict, in which ethnic Armenians occupy an enclave representing about 20% of the area of the country, was the displacement of between 750 and 930 thousand Azerbaijani nationals. The combination of the IDPs (Internally Displaced People) resulting from the conflict and the economic hard times being faced because of the transition to a market economy after the collapse of the Soviet Union, created a major employment and social problem for the country. Hundreds of thousands of people were left unemployed. Initially they had little or no help or support in putting their lives back together.

During this same time, people were desperately trying to survive, often by starting micro and small businesses. These income generating activities of the urban, rural, and displaced poor proliferated, most frequently gravitating to commerce or services at the microlevel, in large measure due to the "ease of entry" (i.e., low capital investment and skills needed). Rudimentary manufacturing at the upper end of the microenterprise or small-scale enterprise sector also began

² Private Sector Assessment: Azerbaijan; Nathan-MSI Consortium; November 1999

to take shape, particularly among IDPs who had been driven from businesses they had previously operated in their home regions of the country. This effort to create income and employment opportunities initially began as a survival strategy after initial relief aid was exhausted.

These serious socio-economic problems of the early to mid-1990s led to the arrival of the International NGOs and Donors to do what they could to avert human tragedy. Although these organizations came with a specific humanitarian relief objective, after a period, as the immediate disaster relief aspects of their programs began to wind down, they began to focus on longer-term developmental objectives. They then turned their attention to income and employment creation through microlending derived from the clear and perceived felt need of these people. The microenterprise support effort was recognized as a reasonable strategy, and, the NGO community began to develop services to address this set of income, enterprise, and job creation needs and opportunities. The general view was that the medium-term well-being and survival of the IDPs and ethnic groupings scattered throughout Central and Southern Azerbaijan hinged on having a means of economic support at the level of family units. Thus, the NGOs concluded that in addition to short term feeding and longer term housing projects, the best way to help IDPs was to provide them access to resources to create and sustain self-employment opportunities and create family incomes.

As target populations for the original NGO microfinance projects multiplied over the succeeding six years, these organizations reached a universe of people who lacked access to credit. From data currently available, their borrowers have also been able to use the credit at least well enough to achieve loan repayment rates that are in the high 90% range. The USAID-financed NGOs the team had the opportunity to visit, are currently carrying out their programs quite effectively, and with a high degree of understanding of financial and methodological best practices, despite the serious start-up problems that some had to overcome.

The banking system in the mid to late 1990's, when the humanitarian NGOs arrived to fill the microcredit void, was very weak. And, it continues to be weak today. The legal and regulatory systems for supporting private sector banking and finance are also weak or unenforced. As has been noted in many other reports to USAID there are many constraints to financial services for business development. These include weaknesses in the ability to put up collateral based on private ownership, enforceability of contracts, attracting deposits to the private banks as a source of bank capitalization, and lack of financial products that facilitate capital investment such as leasing arrangements.

Even now, there are virtually no registered banking institutions that will provide credit to micro-enterprises. The same can essentially be said for small-scale enterprises as well. As for medium sized businesses, there is some banker interest in them, but only if the enterprise or the principal owners or managers are known to the bankers. The formal banking and financial institutions are often throw backs to the old system where banks had their clients and lent on the basis of central directives or within a base universe of clientele. Loans were not, and still are not, made on the basis of merit. Much of business finance is based on whether the businessman and the banker know each other, and whether additional fees and charges over and above normal levels are made.

B. SUMMARY OF THE PROGRAMS OF USAID-FINANCED CREDIT INTERVENTIONS

Four USAID-financed organizations are located programmatically and organizationally within Strategic Objective 3.1: Reduced Human Suffering in Conflict-Affected Areas. Three are under Strategic Objective 1.3 Accelerated Development and Growth of Private Small and Medium Enterprises in Targeted Areas. As mentioned earlier, an original priority for USAID's NGO partners in providing microloans was humanitarian in focus given the economic and complex "disaster" (armed conflict) being experienced by Azerbaijanis, generally, and Internally Displaced Persons (IDPs), specifically, during almost the entire decade of the 1990s.

Microfinance offered an entry point intervention that satisfied the first steps in moving from strictly relief activities to ones that had longer-term income and employment generation impact potential for the target populations of the humanitarian relief projects.

As time advanced, USAID and its microfinance partners, made significant advances along the "continuum from relief to development." The initial humanitarian benefits of NGO credit activities, while, reducing human suffering, began to have significant economic impacts on both the final clients and on the institutionalization of the credit programs themselves. Project designs and methodologies were implemented that would improve the prospects for the sustainability of these projects over time.

The opportunity for relief recipients to begin to return to self-sufficiency and to have on-going, sustained support from projects offering a wider range of credit products became important objectives for USAID and its microfinance partners. The line between S.O. 3.1 and S.O. 1.3 became blurred with overlapping projects under both strategic objectives simultaneously fulfilling the objectives of two different S.O.s.

The S.O.3.1 Partners in NGO Microfinance activities represent the first tier in the continuum. They provided the first opportunity for relief recipients to generate some income and re-establish a modicum of economic self-sufficiency. The first stage of the USAID program was to provide microloans (primarily in trading, services, and truck farming/market gardening) to enable people to reduce their dependency on relief. The follow-on incremental increases in loan sizes, following microfinance best practices, has allowed clients to continue to increase family incomes (or produce food for family consumption) while decreasing their dependency on relief and remain within the overall framework and focus of S.O.3.1.

As the credit activity continued, and credit clients moved into second and third lending cycles, it became increasingly clear to practitioners that demand existed for larger loans. As their own original clients' credit needs grew and other, larger businesses began to approach their projects, some USAID partners began to add different financial products and lending methodologies to their programs in response to demand.

The USAID Azerbaijan Strategic Plan 2001-2003, clearly delineates through S.O.1.3 the Mission's recognition of the need for a refined, highly developmental emphasis in the USAID program for Azerbaijan. New financial products to meet greater income and employment creation and business development needs were needed as USAID shifted along the relief to development continuum. Microfinance projects, even though they primarily followed USAID's

Microfinance Best Practices standards, fit into the S.O. 3.1 framework and objectives, while more typically enterprise credit operations, with focus on economic development and business growth objectives, fit best into the S.O.1.3 framework.

Below is a summary of the primary USAID-funded credit operations in Azerbaijan followed by descriptions of their operations.

TABLE 1

Primary Microfinance Institutions in Azerbaijan with Loan/Portfolio Characteristics*

Name of Organization	Nº of Micro and Small Clients (2001)	Nº of Clients By 2003 (3 Years) (Est.)	Nº of Clients By 2005 (5 Years) (Est.)	a. USAID Capital for Loans & b. Current Port. Outstanding (US\$)	Portfolio Growth By 2003 (3 Years) (%)	Portfolio Growth By 2005 (5 Years) (%)	Additional Capital Needed** (US\$mil)
<i>S.O 3.1NGOs</i>							
ADRA	360 loans within 45 groups	1,200	3,000	a. \$570,000 b. \$140,000	18-20% (9-10% annually)	40%	NA
IRC	473 in 77 groups	No	No	b. \$ 75,000	No	No	No
World Vision	1,770	4,500	6,300	a. \$180,000 b. \$870,000	300%	440%	
Save the Children	2,085			a. \$307,000 b. \$225,000			
<i>S.O.1.3 NGOs</i>							
ACDI/VOCA	60 in 2001	NA		a. \$3.0 m b. \$300,000			
FINCA	3,400						
Shorebank Overseas Azerbaijan	70	No	No	a. \$500,000 b. \$370,000	No	No	No

Source: Each Agency listed above provided its own statistics.

1. USAID'S CREDIT OPERATIONS UNDER S.O.3.1

➤ Mercy Corps International

Mercy Corps International (MCI) manages the Azerbaijan Humanitarian Assistance Program (AHAP) umbrella grant from USAID that is providing administration oversight and funding to the following implementing partners.

- Adventist Development & Relief Agency (ADRA)
- International Rescue Committee (IRC)
- Pathfinder International (PI)
- Save the Children Federation (SCF)
- World Vision

The Azerbaijan Humanitarian Assistance Program (AHAP) is managed by Mercy Corps through an umbrella grant from USAID. The AHAP has been operating for forty-two months and has been extended for another three years to run through January of 2004 with a total estimated cost of \$45 million. During the period December 2000 through May 2001, the AHAP economic opportunities (EO) programs supported business activities for IDP and conflict affected clients residing in Southern, Central and Naxchivan regions through the provision of financial and business development (BDS) services. The programs impacted 7,800 recipients directly, of which 53% were IDPs and 49% female. The financial services' programs had stable growth in income due to high client retention and repayment rates (98%), which led to higher than expected average operational self-sufficiency ratios of 48%. The microcredit products are reaching emerging entrepreneurs and enable clients, primarily traders and farmers, to improve their economic conditions. Because credit was available for the purchase of agricultural inputs, hundreds of farmers in Mercy Corps financed credit operations have been able to plant on recently privatized land that would otherwise have been underutilized. Some of the produce is sold in the markets, but much of it is used for family consumption.

During the last six months, the programs delivered 3,360 microloans, which sustained 3,200 full time jobs. Also, 715 jobs were created. These achievements are 55% higher than the last period due to high demand and rapid expansion of programs. Individual loan products are now targeting small businesses; such products traditionally lead to job and business creation.

➤ Adventist Development and Relief Agency

In 1999, the Adventist Development and Relief Agency (ADRA) was awarded a \$500,000 grant from Mercy Corps International, the grant administrator in Azerbaijan of the US Agency for International Development. These funds, complimented by \$70,000 from ADRA, were used to implement an 18-month phase of the Nakchivan Agriculture and Microenterprise project (N.A.M.E.) that ended on October 31, 2000.

Nakchivan, an autonomous region of the Republic of Azerbaijan, is bordered by Iran, Armenia and Turkey. Populated by Azerbaijanis, it was connected to Azerbaijan until the Nagorno-Karabakh conflict of 1989 - 1993 when Armenia seized the western part of Azerbaijan and cut Nakchivan off from the rest of the country. This is the only USAID-funded NGO operating in Nakchivan at this date.

This microfinance service delivery model is a hybrid that modifies conventional ‘group-lending’ to incorporate some of the benefits of individual lending in terms of accountability and physical collateral guarantees. Two lines of credit are available: the external account (EA) and the internal account (IA). The external account consists of ADRA loans to individual members of Credit Associations. The internal account consists of members savings, interest earned on IA loans, and other group equity. EA loans are delivered directly to individual borrowers, and not via on-lending from the Credit Association. However, loans are delivered only to persons who are bona fide members of a participating Credit Association. The Credit Association will be eligible for new loans when all members have repaid current loans.

Credit Associations consist of 19-20 members. The rationale is (a) that serving larger groups is more efficient, and (b) that larger groups result in lower risk of the ‘strongman syndrome’ where all individual borrowers concentrate funds in the hands of one dynamic group member who may, or may not, be credit-worthy. The purpose of these Credit Associations is to guarantee members’ loans (each member guarantees every other), provide mutual assistance in problem solving, and provide support for joint production and marketing, as well as to provide forums for community discussion of economic issues, priorities, and strategies.

The purpose of EA loans is to provide working capital for microenterprise activities in two broad industries as follows:

ASL (Agriculture and Animal Husbandry)

Initial Loan Size	\$200
Term	40 weeks
Interest Rate	3%/month charged on the outstanding balance of the loan
Payments	Monthly (savings/interest/principal) 45% of principal to be paid during the cycle and 55% in final payment
Administrative Fees	\$3.00 standard fee per loan

TSL (Trade/Production/Services)

Initial Loan Size	\$200
Term	16 weeks
Interest Rate	3%/month charged on the outstanding balance of the loan
Payment	Principal and Interest Monthly (15% per month for 3 months, and 55% in final month)
Administrative Fees	\$3.00 standard fee per loan

Loans are guaranteed through the following methods:

- Solidarity group guarantees (each group member guarantees every other in the case of ASL, and each group member guarantees the member of his sub-group in the case of TSL).
- Pledge of physical assets as collateral (at least equal to the value of the loan).
- Clients’ savings. Group members shall be entitled to garnish client savings, if necessary, to repay a delinquent external account loan.

The program has provided 360 loans to individual clients in 45 village-based Credit Associations, with 96% repayment of loans due to date. Portfolio at risk is 1%.

➤ **International Rescue Committee**

The International Rescue Committee (IRC) is primarily a humanitarian organization focussed on refugee issues. It has been engaged in microfinance activities in Azerbaijan since 1996. The IRC focuses its microfinance efforts on the IDP population in and around Barda, Agdam, Agjabedi, Tartar, Beylagan and Imishly. It received \$75,000 from USAID via MCI.

The IRC services 473 borrowers in 77 groups with a total outstanding loan portfolio of \$75,000. They are not making loans to new borrowers as this loan program is closing down. Their loan program features are summarized below.

IRC

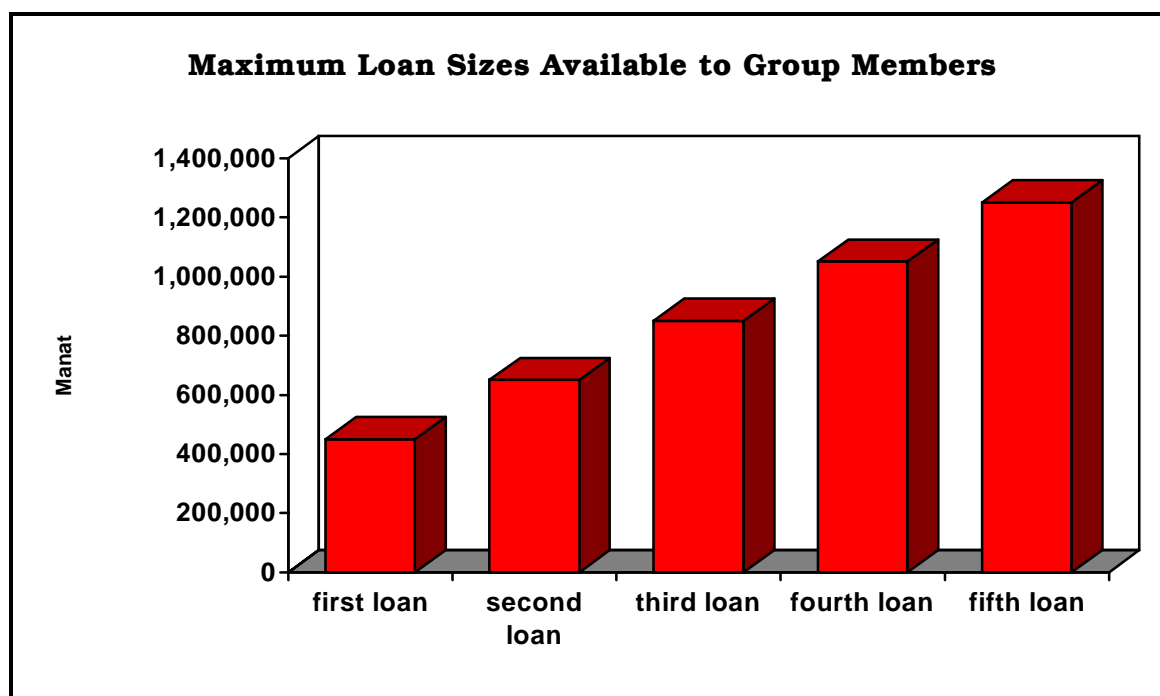
Loan Size	\$200 to \$700 issued in AzM
Interest Rate	4 %/month declining
Loan Period	5 to 12 months
Arrearage	-0-

➤ **Save the Children Federation**

The Save the Children Federation (SCF) Community Based Lending and Savings program (CBLS) was initiated in June of 2000. Mercy Corps International funds the program. The mission is to provide access to financial services to microentrepreneurs, primarily women and predominantly IDPs in order to increase the profitability of their enterprises and, in turn, increase their household income.

CBLS loans are issued for business purposes only. Group members (5 to 15) are responsible for ensuring proper use of borrowed funds. The CBLS methodology involves making small loans to groups, who receive loans as individuals but guarantee the loan as a group. Loans are offered to groups of all men and all women not mixed groups. Loan contracts are between SCF and the entire group with each group member signing the contract and guaranteeing the entire loan. Members are jointly and severally liable for loan repayment. The total size of a loan available to the group is the sum of individual loans that group members are eligible for and request.

Loan Sizes: The first loan must be 450,000 Manat. Groups with late payments may not be allowed to increase loan amounts and may not be granted any additional loans. Loans may not be rescheduled or refinanced. This “ratcheting up” approach is described in the chart below and is a tenet of best practices that is used by the USAID-financed loan programs visited in Azerbaijan.



Source: Save the Children, 2001

The features of the SCF loan program are:

SCF

Loan Size	450,000 Manat
Interest Rate	Simple 16% for 16 weeks; 14% on subsequent loans
Late Payment	0.5% per day

Each month the CBLs Program ensures the security of the loan capital by reserving a provision against possible loan defaults. The provision is based on the late payments aging schedule of the portfolio. SCF has served 2,085 clients.

➤ **World Vision Azerbaijan**

World Vision Azerbaijan (WVAA) was initially designed to meet the needs of refugees and IDPs arising from conflict between Azerbaijan and Armenia. The program started its operations in late 1995 working both in urban and rural areas, providing services mainly to people working in trade and agriculture. The program was funded primarily through grants from USAID through Mercy Corps International and the Azerbaijan Agency for Reconstruction and Rehabilitation of Areas (ARRA) financed by UNDP.

WVAA disbursed over 7,000 micro and small loans and has affected the lives of more than 30,000 people creating and sustaining 14,000 jobs for the poor and disadvantaged. However, the program ran into serious delinquency problems in late 1998. Starting in September, 1999, WVAA has addressed these problems, with a revised lending methodology and human resource policies.

At present WVAA is working on becoming a national microfinance institution to serve low-income entrepreneurs, IDPs, refugees, and the local resident population in all regions of Azerbaijan. WVAA intends to grow its program to work with both group-based microcredit and small individual loans. The Program will work in both urban areas for trade, production and services, and rural areas for agriculture and livestock breeding. The immediate focus is on continuous improvement of the overall program; intensifying staff capacity building; training geared towards creating a professional team; scaling up to reach more clients; and achieving operational sustainability within the next 6-12 months.

WVAA has group and individual loan products. Efficient and effective provision of financial services relies heavily in the establishment of a sound long-term relationship with clients. Credit Officers provide training and consultation to improve clients' capacity to put a business plan together and to keep simple accounting records.

The products offered by WVAA have been designed based on community needs and the economic level of entrepreneurs as shown in the following table:

Characteristics	Simple accumulation Solidarity group loan	Amplified accumulation Individual loan	Expansion Fixed Assets
# Of employees	0-1	1-3	3-25
Assets	To \$1,000	To \$2,500	To \$10,000
Sales per month	\$200-\$1,500	\$1,500-\$5,000	\$5,000-\$10,000
Profit Reinvested	No	Some	Yes
Profit Distributed	Yes	Yes	Yes
Access to Financial Services	No	No	Yes
Minimum & Maximum Loans \$	\$150-\$1,000	\$150-\$2,000	\$2,500-\$10,000
Guarantees Available	Assets=>the value of loan desired and/or Peer Cosigners	Business and/or Personal Fixed Assets and/or two salaried Cosigners/Gold	Mortgage and/or two salaried Cosigners/Gold

As of 01/08/2001 the loan portfolio of WVAA is financed by

- USAID/MCI-\$181,000
- \$45,000 of loan grant from CIDA
- A loan of \$20,000 from WV Canada as a match to a pilot CIDA project
- A loan of \$100,000 from MEERO
- A loan of \$100,000 from WV US
- \$600,000 under a project funded by UNDP/ARRA

WVAA's lending is summarized below:

WVAA

	As of 7-31-01
Average loan size disburse during period	610
Number of loans outstanding (end of period)	2,431
Value of loans outstanding (end of period)	869,147
Average loan term (months)	10.0
Loans past due more than 30 days #	91
Loans past due more than 30 days \$	19,910

2. USAID'S CREDIT OPERATIONS UNDER S.O.1.3

➤ ACDI/VOCA

Since 1998, ACDI/VOCA has received funding for its Farmer to Farmer technical assistance program in Azerbaijan. In the process it got to know the problems and needs of rural Azerbaijan well and presented a proposal one and a half years ago to USAID for funding of a rural credit system under the auspices of a centralized non-bank limited liability credit organization, "CredAgro". The proposal was accepted and CredAgro currently has six branch offices, covering Masalli, Gelilabad and Lenkoran in the South, Ismaili in the center and Zaqatala in the NorthWest, plus Baku/Absheron. Three other regions with good farming conditions have been targeted for branch expansion. After six months of delays and bureaucratic red tape, CredAgro has been registered as a non-banking credit institution allocating loan capital fund to individual credit cooperatives throughout Azerbaijan. They, in turn, issue individual and group loans to the borrowers.

The program focuses on developing the technical and management capacities of farmers, refugees, processors, privately-based agricultural information systems, and other agro-enterprises. In developing this program ACDI/VOCA-Azerbaijan established a centralized management, oversight and funding mechanism for its credit system recognizing the weaknesses and potential management problems in developing effective organizations in Azerbaijan. ACDI/VOCA's intent was to run CredAgro with a firm hand from the beginning. Later, as the different regional offices began to gain experience and demonstrate their ability to work effectively and honestly, then authority would be progressively delegated to them.

CredAgro has a President, Vice President and a Chief Accountant responsible for implementation and monitoring of the credit operations and relations with the individual credit cooperatives. Other Project staff includes a credit specialist, loan officers, an accountant, lawyer and other technical support. In addition to managing and directing the flow of loan capital to individual credit cooperatives, CredAgro's role will be to secure additional loan capital funds.

The role of the credit cooperatives will be to collect and submit loan capital back to CredAgro, which retains the capital for future lending purposes only. For as long as there is overhead and human resource support to CredAgro through ACDI/VOCA, all interest income net of taxes will be added to loan capital and loss reserves. Credit cooperatives will use a similar loan capital management structure, when the proposed system is implemented soon.

Loans are to be channeled through CredAgro, although control of the loan capital will be retained by ACDI/VOCA. ACDI/VOCA provides oversight of the entire system. First loans went out on May 1, 2001. About 60 loans have been disbursed for a total of about \$300,000. ACDI/VOCA/CredAgro is using a standard repayment schedule for various loan types (see table below) that will be subject to change due to changes in regulations, business environment, individual credit rating, etc.

Type	Average Size (Thousands US\$)	Term (Months)	Interest (%)	Repayment
Crops	3-5,000	12	18	Interest-monthly Principal-end of loan term
Livestock	3-4,000	12-18	18	Interest-monthly Principal-quarterly
Ag. Trade	1-2,000	6-9	25	Interest-monthly Principal-quarterly
Processing Equipment	NA in year 1	NA in Year 1	18	Interest-monthly Principal-quarterly

➤ **FINCA Azerbaijan**

FINCA opened a new Village Banking program in Azerbaijan in 1998, in an effort to provide support to the growing ranks of microentrepreneurs. However, FINCA Azerbaijan was forced to suspend lending midway through its first year of operations because of new tax laws that would have caused a dramatic increase in operating costs. In response, the program hired a lawyer and applied for a limited license from the Azeri Central Bank.

FINCA Azerbaijan has been able to continue lending in the areas of Baku, Absheron, Imishly, Saatli and Sabirabad, despite some recent internal actions in Baku and some internal supervision problems.

FINCA Azerbaijan's clients are mostly women involved in market trade and selling food products.

A summary of FINCA Azerbaijan's USAID-funded activities is below:

FINCA

Loan Size	\$100 to \$500 (issued in Azm, loan amount increased depending on # of cycles)
Interest Rate	4% monthly & flat
Loan Period	3 to 24 weeks (period increased depending on # of cycles)
Total Loan Outstanding	\$290,000
Number of Clients	3,400
Arrearage	10% beyond 30 days
Write-off as % of Total Disbursements	0.24%

➤ **Shorebank Overseas Azerbaijan**

Shorebank Overseas Azerbaijan (SOA) Advisory Services began a five-year "Caucasus SME Finance Program" (CSFP) in 1998 to promote grass roots economic growth and regional integration in Armenia, Azerbaijan and Georgia. The primary focus of the program is to create and promote financial products and institutions that meet the needs of small businesses at the higher end of the MSME spectrum in the Caucasus countries. Over \$16 million in funds have been disbursed through 12 intermediaries.

The Azerbaijan project was established in 1998 and manages an independent credit program with \$500,000. Loans outstanding are currently \$420,000 and total disbursements are about \$670,000 with just over 70 loans. This five-year program is set to expire in September 2002.

Shorebanks' direct lending with USAID funding is summarized below:

SOA

Loan Size	\$1,000 to \$50,000
Interest Rate	2% to 3.5% per month for trade, service and production.
Loan Period	Most loans around 12 months
Number of Clients	About 70
Regions	Baku, Sumgait, Lankaran
Arrearage	0
Writeoffs	0

➤ Related Shorebank Activities

In addition to its USAID-financed credit operation, Shorebank also has been providing technical assistance to three local commercial banks selected by IFC, in disbursing of IFC loans. Shorebank's primary interventions were to backstop local institutions with training, technical assistance, and networking. Their efforts were meant to complement other financial initiatives and help strengthen local financial institutions. However, the Azerbaijan IFC/SMSE program has made no loans since September 2000, due mainly to IFC concerns over the stability of the banks.

It must be noted that hundreds of banks have closed in the past two years particularly due to new capitalization requirements. The SOA partner banks are small and highly undercapitalized with assets of between about US\$1.0 – \$1.5 million. In addition to their fragile capitalization base, these partners are exceedingly risk adverse and, according to our information, prefer not to work with borrowers outside their known base, a typical situation in the formal financial institutions in the country and a reflection of the old ways.

SOA activities have therefore been limited to monitoring and assisting the banks in dealing with problem loans. Total cumulative figures are currently 47 disbursed loans worth \$1,530,000. There have been three write-offs under the IFC program for a total of about \$140,000 (nearly 10%). Arrearage is \$38,000 on a rapidly declining portfolio of \$118,000.

Shorebank has informed the IFC that it is not interested in providing further technical assistance to Rabitabank and Azerigazbank. The reason for this decision is that both banks have failed to fully embrace prudent and progressive lending methods. As a result, Shorebank believes that it is better to devote resources to the SOA direct lending program as the most effective way to reach SMEs in the last year. Also there is concern that the two banks have incurred losses and reduced their already limited capital during the past year.

Since Shorebank senior management in the US has decided not to extend the lending program, Shorebank management is considering alternatives for the SOA direct lending portfolio, including the transfer of their portfolio and customer list to the pending MicroFinance Bank of

Azerbaijan, which is scheduled to be established by the end of this year. This bank is proposed by EBRD, IFC, KFW and the Black Sea Trade & Development Bank with capitalization of \$5 millions. The local commercial banks have not expressed an interest in purchasing founding stocks.

C. INTEREST RATE ISSUES

Interest rates of 3% to 4% percent per month, as shown in the table below, for USAID-financed MSME credit programs, have been criticized by some in Azerbaijan as being inappropriately high. However, before making that judgement, it is important to understand the pricing of loans that underlies interest calculations and the negative ramifications of subsidized interest to enterprise development and economic growth in general. Interest charged at a rate below that required to cover the costs of operating a loan fund including the depreciation in the value of the fund in real terms, as reflected in the rate of inflation of a country, is considered to be subsidized. Subsidized interest rates do not reflect the real cost of the loans. They clearly benefit a few borrowers on a loan by loan basis, but will eventually make financial and/or operational sustainability of the lender impossible.

Furthermore, subsidized interest will always eventually limit credit availability in the marketplace. Funds for lending will not be generated from internal private sources at subsidized rates and will, by necessity, continue to be donor financed. Donor financing, in turn, will always be limited in terms of the needs of the market. Thus, the long-term economic and financial benefits of subsidized credit projects, will be limited and may actually be negated, since there may well be no on-going availability of loan capital, which, in turn, may also mean the end of the businesses that were financed in the first place.

At the MSME levels, most borrowers cannot currently qualify for loans from commercial sources. Therefore, the USAID-financed MSME lenders are providing loans to the targeted universe of clients, for the most part, as “lenders of last resort”. The delivery system had to be built from the ground up in each market, including the supervisory aspects of the projects. The cost of lending, particularly for microlenders, is, therefore, unavoidably costly on a per client or per loan basis.

Therefore, the interest charged by MSME lenders needs to be at the 3.5% to 4.5% levels in order for them to be viable. The team observed that typical borrowers seem to understand this essential interest cost issue as contrasted to the critics of real rates of interest (that is, unsubsidized). They were more concerned about the current and future availability of funds with longer terms than they were about the current level of interest.

To explain their reasoning, borrowers interviewed by the team said that simply by having the working capital provided by the loans, each time they went to the Baku Airport Market they were able to purchase merchandise at 10 % to 15 % below the asking price by offering cash. In contrast, without access to credit they would have had to pay full price as well as 5% to 10 % in interest to the supplier for financing the goods for one to two weeks. Thus, they recovered a significant amount of their actual interest costs solely on the basis of each purchase of inventory. This simple analysis, alone, indicates the value of the credit program to businesses that otherwise would not have access to credit.

The comparison below provides a summary of the interest rates charged by the USAID financed MSME credit projects throughout the country.

Level of Interest Rates by Credit Institution

Name of Organization.	Current Interest Rate Converted to Monthly	Basis for Computation
ADRA	3.0%/month	Declining – Outstanding Balance of Loan
World Vision	3.0-5.0%/month	Declining – Outstanding Balance of Loan
IRC	4.0%/month	Flat – Original Loan Balance
Save the Children	4.0 % / month	Flat--Original Loan Balance
ACDI/VOCA Ag. Production	1.5%/month	Declining – Outstanding Balance of Loan
Ag. Trade	2.0%/month	Declining – Outstanding Balance of Loan
FINCA	4.0%/month	Flat – Original Loan Balance
Shorebank Overseas Azerbaijan	2.0 to 3.5 % / month	Declining--Outstanding Balance of Loan

In Chapter III, the six major issues of the SOW are discussed in the context of the environmental and institutional information just presented.

CHAPTER III: ANALYSIS OF ISSUES RELATED TO MICROENTERPRISE AND SME FINANCE IN AZERBAIJAN

The principal objective of this report is to provide USAID with an assessment of six issues related to Microenterprise and SME finance in Azerbaijan. These issues, as specified in our Scope of Work, are:

- Issue 1: Major constraints to access to credit;*
- Issue 2: Demand for and supply of credit and related products and services;*
- Issue 3: Demand for new and expansion of existing products;*
- Issue 4: Strengths, weaknesses, opportunities and threats relating to USAID-funded credit institutions;*
- Issue 5: Prospects for the sustainability of microfinance institutions; and,*
- Issue 6: The transition from humanitarian relief to enterprise development credit.*

Our questionnaire responses, personal interviews with project staff and clients, USAID personnel, and other financial sector players serve as the basis for the findings, conclusions, and recommendations presented below.

ISSUE 1: MAJOR CONSTRAINTS TO ACCESS TO CREDIT

As has been the case with many of the Republics of the former Soviet Union, Azerbaijan has experienced a difficult economic and political transition from a command economy and centralized political system to a market economy. The social and economic ramifications of this change have included high unemployment, sub-subsistence wages, lack of the old social safety net, and poverty, and have made life difficult for the average Azerbaijani.

Azerbaijan still has not embraced market-oriented capitalist methods. But, the Azerbaijan citizen continues to use the trading tools of capitalism in order to try to sustain self-sufficiency. While the country has moved somewhat in the direction of more market orientation and western standards in their ways of doing business and running the economy, Azerbaijan has resisted change.

The institutions, laws, regulations, and essentially the socio-economic fabric of society needs to be rewoven to meet the new approaches being fostered by Western institutions such as the European Union, the IBRD, and many bilateral donors, including the United States. But, the political will to make these adjustments, while gradually increasing in the past several years, is still lacking and not proactive

Consequently, the development of NGO-based microfinance projects in Azerbaijan has been largely carried out in an institutional, legal, and regulatory vacuum. Laws, regulations, and institutions really did not exist under the old system for this type of lending program.

Private small business credit projects in Azerbaijan began with a focus on providing funds needed to save existing jobs, create new employment, and generate income in IDP communities that had been created by the Nagorno-Karabakh dispute. These initial projects were focussed on providing small loans to groups and individuals under typical microfinance methodologies being

used by organizations around the world. These initiatives were initially more humanitarian than economic in focus.

USAID-financed NGOs were an integral part of the initial microlending initiatives and played a major role in bringing microfinance “best practices” to Azerbaijan. Clear development objectives were promoted by projects under USAID auspices targeted on IDPs. Later, these projects included regular local inhabitants fitting the microfinance selection criteria. By their very nature, best practices techniques bring a more developmental aspect to microlending by insisting on implementation methodologies that will create on-going loan funds and sustainable implementing institutions in the medium to long term.

Projects under the humanitarian assistance strategic objective S.O.3.1, over time, began expanding their typically welfare-based relief efforts aimed at ameliorating the immediate problems of food and shelter and averting human tragedy, to incipient, longer-term, sustainable development at the enterprise level, derived from assistance to microenterprises.

As the USAID-financed microcredit projects took shape and the word got out that credit was becoming more readily available, problems began to surface. This was partly because projects were technically working on an informal basis without a clear legal basis. As the projects grew, there was more awareness among entrepreneurs, the public sector and formal financial sectors of incipient non-bank microcredit operations. This led to the raising of such issues as the legality of the implementing organizations, and to the level of interest rates, that were considered usurious, being charged.

The constraints on microfinance organizations, particularly in the legal and regulatory spheres, began to be recognized and felt, as projects expanded. The FINCA Project, for example, had to suspend operations for about one year due to a confrontation with public sector officials. There ensued long delays in obtaining the non-bank license enabling FINCA to lend and collect funds, but not take deposits. Other organizations are caught up in this type of constraint now, as they work through the licensing process.

Increasingly, as USAID expanded the use of microcredit from primarily being a tool for reaching short range humanitarian-based objectives, as a lender of last resort, to concentrating on longer term economic results, projects also began to interface more directly with former Soviet style formal sector banks and larger small and medium scale businesses. This direct contact with the formal financial and business sectors, brought into even clearer focus the problems that more visible, longer-term formal credit operations, dealing with larger enterprises, with clear economic and enterprise development objectives, would have in organizing, registering, financing, and implementing their programs.

To address the issue of major constraints to access to credit, the team gathered information through questionnaires and interviews in terms of the following analytic categories: Legal; National and Local Regulatory; Operational (within institution); Operational (outside institution); Source of Funds; and Stability of National Investment Climate and National Monetary System. Respondents were asked to provide their judgements with respect to the major constraints to access to credit and for corrective actions that might be taken. Summaries of the most frequently identified constraints are provided in Table 2.

TABLE 2**Major Constraints to Increased Credit Access in Azerbaijan**

Category	Constraints Reported In Order Of Frequency
Legal	<ul style="list-style-type: none"> • Lack of specific legislation providing a clear legal/tax status for microfinance institutions. • Difficulty in foreclosure/legal procedures. • Excessive official notary service fees. • Difficulty in registering collateral. • Cumbersome business registration procedures.
Regulatory	<ul style="list-style-type: none"> • Lack of uniformity in application/implementation of laws and registrations. • Unfair and complex tax laws/high taxes (some use of banks to scrutinize borrower files looking for tax information). • Corruption and bureaucratic procedures (force lenders and borrowers to resort to bribery to conduct many transactions). • Emphasis on control vs. facilitation (Example action against street vendors).
Operational (within institution)	<ul style="list-style-type: none"> • Inadequate funds for training/capacity building. • Insufficient capitalization to achieve sustainability.
Operational (outside institution)	<ul style="list-style-type: none"> • Grant mentality due to prior and present subsidized programs (failure to use best practices). • Shortage of skilled finance personnel. • No national capacity building (micro finance awareness/training/coordination).
Source of Funds	<ul style="list-style-type: none"> • Reliance on donor funds. • Weak banks (lack of confidence resulting in low deposits). • Donor behavior (failure of some donors to require best practices leading to loan fund sustainability problems.) • Funds primarily of a short-term nature.
Stability of Investment Climate & Monetary System	<ul style="list-style-type: none"> • Corruption/bribery. • Tax system. • Some mistrust/hostility toward foreign organizations providing credit.

In tables 3.1 through 3.5 we provide a summary of the team's assessment of the current situation with respect to each of five analytic categories on the basis of interviews, observations and questionnaire results. The Tables also include a summary of corrective measures proposed by the respondents to the Team's questionnaire. The Team's recommendations with respect to each category of constraint are presented separately, following the set of Tables.

TABLE 3.1

Corrective Measures for Increasing Access to Credit: Legal

Commentary

- The application/implementation of laws and regulations is inconsistent. Judges are not familiar with how their peers are ruling from one jurisdiction to another. Therefore, laws and regulations are applied in a haphazard way, primarily reflecting the will of any given judge.
- Each case is essentially a new one, it would seem, and judges, we are told, do not care very much about precedent. Because precedent is not very important in the implementation of the legal system as it relates to business/finance, those implementing the system are prone to follow their own perceptions of how things are, or should be. Extra-official transactions and other favors that increase the time and cost of decisions and credit transactions in Azerbaijan, are used consistently to expedite or influence decisions for all sizes of enterprises.
- Specific efforts by the IFC and the Bank's Association to get notary fees reduced for collateral registry had a degree of success, getting Agricultural Loan fees reduced to 50,000 Manats. However, notary fees, of 300,000 Manats for collateral registry, remains costly for other loans. Notary fees at this level are a deterrent to potential borrowers.
- Privatized property is difficult to register officially as collateral, because property title can often not be proven. What's more, it is almost impossible; we are told, to find judges that will outright make an ownership decision, even if ownership is clear.
- Obtaining an indisputable security interest in property is not possible under present laws and systems. Lenders are unable to protect their loans with sound collateral due to lack of proper legislation and lack of a unified registry for recording security interests. Accordingly, lending activity is limited for otherwise creditworthy businesses.

Corrective Measures

- Draft legislation providing clear and fair legal and tax status for non-bank financial institutions and develop procedures for uniform enforcement.
- Establish mechanisms for uniform nationwide application/ implementation of laws and regulations related to finance and taxation for micro and SMEs. This might be implemented via some type of vehicle, (maybe through an NGO-based working group such as the credit reporting agency being implemented by the NGOs currently on their own) to keep track of precedents in the application of legislation.
- Draft Civil Code providing sound support for lending activities (efficient and low cost collateral registration in a nationwide security interest filing system, prompt and effective legal action against defaulting borrowers)
- Further reduce notary fees for micro and SMSE loans to at least the level now approved for agricultural credit.
- Establish improved and simplified procedures for business registration.
- Develop a standard process to expedite the delivery of land titles for recently privatized land.
- NGOs should assist the Bank's Association in the continuing & effective lobby of government in banking and finance rules and regulations including the issues regarding registry of collateral and leasing.

TABLE 3.2

Corrective Measures for Increasing Access to Credit: Regulatory

Commentary

- Each report from international organizations, our meetings with organizations, and individual interviews with entrepreneurs/borrower clients of micro and small business lending institutions, made it very clear that legal and regulatory environment often relied on under-the-table payments for required tasks to get done. Otherwise, long delays in getting required documents, permissions, approvals, and the myriad other tasks done could be expected.
- As long as it is advantageous for both the regulator and the business to receive and pay discounted rates on fees and charges, or to sell and buy documents or services through illegal extra-formal operations, corruption will continue, draining valuable time and resources from already undercapitalized businesses. The opportunity cost to businesses caught in this unavoidable web is very significant to the development of the tens of thousands of microenterprises and small businesses needed to establish the entrepreneurial roots of the emerging market economy in Azerbaijan.

Corrective Measures

- Establish measures to reduce the level of petty corruption caused by the lack of institutional procedures at the level of the regulatory bodies, ineffective rules and regulations, and sporadic “cast of the die” style enforcement.
- One solution is to earmark a small portion of the proceeds of the new Oil Fund to pay better public sector salaries to petty bureaucrats.

TABLE 3.3

Corrective Measures for Increasing Access to Credit: Operational (Within the Institution)

Commentary

- As microfinance organizations continue in their quest for organizational development and operational and/or financial sustainability, one of the greatest needs within institutions, will continue to be in the area of technical assistance and training. Training employees and management personnel in microfinance best practices and institutional development, including understanding sustainability, has clearly been used very effectively by most of the International NGOs currently operating in Azerbaijan.
- Some practitioners are concerned institutional development costs are very expensive and would ruin changes for sustainability, if accounting for costs includes this type of expense.
- The resolution may be that technical assistance and training be viewed in a category of cost that is counted as a contribution to the institutional development process and should be separated out from the calculations to determine loan fund financial and/or operational sustainability.

Corrective Measures

- Encourage more funding for training/capacity building within credit projects.
- Encourage implementing organizations to address capitalization requirements for sustainability before approving initial funding of credit programs.

TABLE 3.4

Corrective Measures for Increasing Access to Credit: Operational (Outside the Institution)

Commentary

- Microfinance is an important tool for addressing the plight of start-up and low-income enterprises all over the world. It is one of the best ways to have a short and medium term effect on saving, strengthening, or creating jobs for the owners and for literally tens of thousands of employees of these businesses in struggling economies, including those in transition to market based systems. It is a tool that sets the stage for some of these business people to move gradually to larger businesses, generate employment, and create income for themselves and their families.
- As some of these businesses grow and their owners become more adept at their business skills, they will move into a higher enterprise level, needing additional capital, thus, requiring larger loans and different loan products from when they were at the lower stages of enterprise development.
- As more and more people become accustomed to the concepts of microfinance and paying formal interest to microfinance institutions, the demand will continue to grow very quickly both for solidarity group microloans and for larger individual small business loans.
- As enterprises move through the spectrum of enterprise size and need, there will come a point when they will need other financial services and products.
- With the financial resources coming from the oil and gas sector and the development possibilities that accompany this wealth, coupled with a concerted enterprise development effort, Azerbaijan is in the position to be able to finance much of its own microenterprises and small and medium scale business development activity.
- NGOs are currently sharing information on an informal basis regarding problem borrowers. Banks are informally doing some of the same. Although helpful, this method is not systematic and lacks a process for correcting inaccurate information. The focus on problem borrowers tends to restrict dissemination of positive credit histories of honest borrowers.

Corrective Measures

- Formally establish a nationwide credit reporting agency which would serve as a clearinghouse for banks and NGOs.
- Foster national capacity building in microfinance and SME development.
- Insist on best practice technology, avoiding subsidies for on-going operating expenses.
- Educate potential borrowers on use of credit.
- Support national and international training/exchanges for NGOs and Banks to prepare them for their interface as the NGOs' largest clients might move on to the larger formal Banks.
- Establish greater awareness of the important role international credit organizations play in improving conditions of the poor.

TABLE 3.5

Corrective Measures for Increasing Access to Credit: Source of Funds***Commentary***

- Inflation is relatively low compared to other developing economies, officially at 6%, but some people have said it's closer to 9% and the economy is stable.
- Since lending is done in local currency this says something positive about public perception of inflation and general economic stability.

Corrective Measures

- Establish favorable taxation laws for investors.
- Governmental anti-corruption measures need to be in place soon to attract Investment.

Recommendations: The findings and suggested corrective measures presented above largely confirm the considerable work that had previously been done by USAID to identify constraints and seek corrective measures. Below, on the basis of the information obtained, the team provides three sets of recommendations for overcoming the major current constraints on access to credit in Azerbaijan. These relate to (a) the legal and regulatory system, (b) operational improvements, and (c) the diversification of funding sources. We recognize that many of the constraints identified in this report will require government action because they are rooted in a legal and regulatory environment that is not conducive to private sector, market-oriented economic growth. We also fully comprehend that USAID is constrained by the Freedom Support Act, Section 907 from working closely with or assisting the Government of Azerbaijan in changing the system. Nonetheless, the team believes it is important, albeit frustrating, to place the problems and options on the table, even if there is not much that USAID and the USG might be able to do about some of the constraints in the immediate and short-term future.

(a) Legal and Regulatory System

- 1. USAID should work with its local and international private sector collaborators as well as the multilateral and bilateral donor community to encourage the Government of Azerbaijan to adopt a flat, nominal fee notary system (such as has been implemented for agricultural loans).**

Present security documents for pledging collateral must be notarized. The fee is based on a percent of value of security rather than a flat fee. This is unreasonable and expensive for borrowers. This measure should be adopted as soon as possible and later specified as part of the system mentioned below in Recommendations 2 and 3 below.

- 2. USAID should work with its local and international private sector collaborators as well as the multilateral and bilateral donor community to encourage the Government of Azerbaijan to enact legislation permitting the use of private land and property as collateral on loans.**

Privatization of land and other property, generally, have proceeded slowly. As property is turned over to the private sector, the need for good legislation on the use of private property as collateral will be needed. Guidance to public officials and bankers will also be needed to assure that the law is consistently applied. Success in this effort should ease credit access by expanding the universe of different kinds of institutions willing to make loans to private individuals and small business owners/operators. It will also be very important that good, accurate, timely titling services be in place to back up ownership claims.

- 3. USAID should work with its local and international private sector collaborators as well as the multilateral and bilateral donor community to encourage the Government of Azerbaijan to support legislation creating a nationwide security interest filing system.**

As land and other property are used as collateral there will be a need to know what collateral has already been put up as security on other obligations. There is no central registry where lenders can determine whether others have a security interest in collateral an applicant is pledging to the lender. Although some registries exist for real estate, the records are not complete. The registry should be computerized and handle both moveable and non-moveable property. Such a system coupled with a level playing field for lenders and borrowers and more uniformity in upholding laws should expand the amount of property that borrowers could pledge as collateral for loans

- 4. USAID should work with its local and international private sector collaborators as well as the multilateral and bilateral donor community to encourage the Government of Azerbaijan to enact legislation/clear regulations regarding the status and licensing of non-bank financial institutions.**

The role of and operational limitations placed on non-banks and the process to be used in licensing them, should be clearly established to allow this type of organization to fill a part of the void not presently covered by banks. This includes clearly specifying their tax status. (See the related Recommendation 7 below.)

- 5. USAID should work with its local and international private sector collaborators as well as the multilateral and bilateral donor community to support developing a Civil Code to establish the rights and responsibilities of lenders and borrowers and a nationwide Credit Reporting Agency.**

The current playing field is skewed in favor of the borrower. A civil code establishing a “level playing field” for lenders and borrowers including clear and efficient processes for dealing with defaults is needed. Lenders tend to be conservative when there are difficulties in obtaining information about applicants and collecting from defaulting borrowers. Exchange of credit information on applicants, even such a basic item as if the applicant has an existing loan, is not allowed. A Bill of Rights establishing the rights and responsibilities of both lenders and borrowers could be a first step in developing the civil code.

Additionally, there needs to be a repository for credit information that would serve to report a) diligent borrowers' positive history and b) marginal and defaulting borrowers poor credit records. This could enhance diligent borrowers' opportunities to obtain credit and allow prudent lenders

to screen poor credit risks. Ultimately, this should offer lenders the opportunity to place more weight on an applicant's reputation and repayment history when considering loans.

Finally, the process of enforcing collection against defaulting borrowers needs to be clearly specified for courts and appropriate executing agencies to be able to follow through in a consistent and expedited manner. Part of the difficulty lies in inconsistent application nationwide of existing laws, even by the same judges. (See Recommendation 6 below.)

- 6. USAID should work with its local and international private sector collaborators as well as the multilateral and bilateral donor community to encourage the Government of Azerbaijan to ensure uniformity in implementing laws and enforcing regulations.**

Currently, there is lack of consistency in enforcing laws and regulations. Lenders are uncertain they will prevail in their collection efforts through legal processes. Judges do not refer to previous rulings by other judges in making decisions. They appear to freely render decisions contrary, sometimes, to even their own earlier rulings. A system to make available precedents for reference in making decisions and guidelines for following these precedents could improve the consistency in implementing laws nationwide.

- 7. USAID should work with its local and international private sector collaborators as well as the multilateral and bilateral donor community to encourage the Government of Azerbaijan to enact clear and reliable tax legislation providing simplification of taxation for small businesses.**

Small businesses are reluctant to expand and attract the attention of tax authorities because they assume onerous, illegal treatment. Businesses that don't pay tax are not contributing to the national budget. The authorities, we are told, often pressure businesses for payments in lieu of taxes. When it is accepted that both the tax authorities and businesses are better off cheating, that is probably what will happen. Even buying and selling of different official positions, according to their profitability, we are told, is not unthinkable. A trustworthy system, that includes incentives for honesty throughout the process, is essential to enforceability.

- 8. USAID should work with its local and international private sector collaborators to assure that Foreign Exchange Risk only be transferred to micro and small borrowers who are generating foreign exchange.**

The Azerbaijan Manat is not regarded as a hard currency, so the exchange risk can be considerable if the local borrower is obligated to repay a loan in a hard currency. Funds provided by international donors or international lenders are supplied in hard currency. Banks and NGOs are on-lending the funds in hard currency or in Manats indexed to a hard currency. The result is that borrowers are bearing the foreign exchange risk. For borrowers who are generating foreign currency in the normal course of operations this lending mechanism is acceptable. The majority of small and micro borrowers is generating income only in Manats and should not be burdened with bearing foreign exchange risk. Since the NGOs do not return the USAID funds, there is no reason to cause the local borrower to absorb any foreign exchange risk or cost.

(b) Operational Improvements

- 1. USAID should require all implementing organizations to calculate capitalization requirements for sustainability in their funding requests.**
- 2. USAID should take a lead role in causing each lending institution to do longer-term strategic planning that includes sustainability plans.**

In instances where organizations will not achieve sustainability objectives established for its lending operation, USAID should work with the implementing partner to devise alternative plans to protect the integrity and viability of the loan funds assigned. These plans could include institutional scaling up or opportunities to create affiliations or partnerships in cases where having a self-sustaining loan fund is not desired or possible. Or, they could also include the transfer of the fund (and personnel, where justified or needed) to a stronger/larger organization or establishing a partnership or affiliation with another group to achieve other complementary skills and resources.

- 3. USAID should continue to provide technical assistance and training to banks, NBFIs, and entrepreneurs as they continue to expand their projects and cover the financing needs of MSMEs in Azerbaijan.**

Continued training and technical assistance is needed by all the target organizations and individuals mentioned. The type, contents, and sophistication of training and/or technical assistance interventions will be determined by the kind of organization in question and the level of formality and sophistication at which it currently finds itself. The team believes that USAID has started in the right direction with its different programs of assistance through ACDI/VOCA and Shorebank at the SME level and the Microenterprise level through its partner NBFIs and should continue with adjustments, as needed, based on lessons learned over the past two years.

(c) Diversification of Funding Sources

- 1. USAID should work with its NGO partners and other bilateral and multilateral donors to continue to encourage the development of domestic savings as a source of funding for smaller enterprises.** (See the accompanying brief descriptions of how some NGOs are stimulating local savings in small amounts through their programs.)

Examples of Initiatives to Generate Savings and Internal Loan Funds among NGO Credit Clients

Groups in the Barda area were developing internal pools of funds, which were used in on-lending to group members. Oxfam on-lends to qualified groups at an interest rate of 3% per month (declining balance). The group on-lends to members at 4.5% with the spread of 1.5% being added to a common interest fund established within the group. One Oxfam group also maintains a savings fund that is capitalized by weekly membership fees of 2,000 to 3,000 Manat per person. These funds provide an increasing pool of money for lending. One credit group interviewed by the Team was providing over 22% of the funds it on-lends to members from the common interest and group savings funds. This reduced the group's dependence on-lending from Oxfam. Oxfam reported that one women's group had accumulated the equivalent of over \$3,000 through these capital accumulation mechanisms. Oxfam is exploring with its groups the possibility of developing them into credit unions.

Save the Children groups in Barda have developed similar internal funds from what amounts to retained earnings of borrowers. The interest rate charged by Save on its group loans is 4.5% per month. 1% of the interest on their regular loans is, however, made available to finance a savings fund for the different groups. Essentially, the 1% donated to the savings program by Save represents retained earnings of the group. Thus, the actual interest accrued by the credit operation is 3.5%. The fund is used for projects in the community's best interest, such as wells, improved farm roads, medical attention, or funerals.

Rotating Savings and Credit Association (ROSCAs), known as "laterea" in Azerbaijan, also exist. The groups usually are made up by salaried employees who place a set amount in a pool each pay period. A different member of the group receives the proceeds of the pool each period. Similarly, the members of several of the ADRA group credit organizations in Nakchivan are setting aside savings on a monthly basis to form a pool of internally generated funds for on-lending to members. The loan is for one month and, upon repayment, is revolved to the next member in line.

2. USAID should work with its NGO partners and other bilateral and multilateral donors to foster the development and implementation of a program of deposit insurance for savings accounts to attract savings deposits and to build a national loan fund pool.

There is a high level of mistrust regarding the private banking system in Azerbaijan. Two hundred banks, including many banks that survived over the years on the basis of cronyism, failed in the past several years. Average Azerbaijani citizens lost very large amounts during these collapses. Trust has to be re-established. One tool to lure individuals and institutions back to the private banks would be a deposit insurance program. The insurance cannot correct the weak condition of banks; therefore, standards for offering the insurance through specific banks must be carefully set high to weed out the weakest banks and encourage banks to strengthen their capital base.

3. Leasing needs to be explored more as a larger, longer-term tool for mobilizing resources for small and medium scale business development.

Leasing as a new financial product is at the very beginning stages of development in the country and the legal basis for their operations is still not fully developed, but may be sufficient to get a start. IFC and Turanbank should be consulted on their experiences and the constraints they found.

ISSUE 2: CREDIT DEMAND AND SUPPLY

A second issue of importance the team was asked to address is that of the demand and supply of credit. In the context of the market and with an interest in knowing where possible gaps were in the supply of financial products, we asked questions about the market as a whole, focusing on availability and delivery of financial products. We divided the products by sector, the clientele by size of borrowings, and the institutions by non-banks and banks. The questionnaire was further divided into the following areas:

- Demand for non-bank credit
- Demand for bank credit
- Potential USAID-assisted products

During the course of our work, the team visited a significant number of selected borrowers of different sizes and with different requirements. Questionnaires were sent to both banks and non-bank finance providers. Non-bank providers were questioned about demand for both bank and non-bank microcredit. Banks were questioned only about bank credit. This was because banks traditionally know little about non-bank programs, which was confirmed during the participatory session that included bankers and non-bank credit project personnel. To give a feel for some of these borrowers, we have provided some brief case studies in Attachment 1.

Summary of Findings and Analyses

Tables 4, 5A and 5B provide summaries of the responses from the questionnaires from each of the two major types of institutions. Returned questionnaires and anecdotal evidence from interviews with borrowers indicated overall strong unmet demand for credit. The high level of demand, however, should not necessarily be interpreted as an indication of repayment capacity. Our questions simply measured a level of desire for access to additional credit funds, be they borrowers or lenders. Bank and non-bank respondents attempted to rate demand for a variety of products.

In their assessments, demand for agricultural production loans was 75% more than supply. Similarly the professed demand for micro and transition loans (Table 4) and working capital loans (Table 5A) also demonstrated high demand, often exceeding supply by at least 75%.

TABLE 4

**Non-Bank Respondents Indication of the Percentage that Demand
for Microcredit Exceeds Supply**

			0%	25%	50%	75%	≥100%
Loans	No. & %						
< \$1,000 (USD) (micro)	(9 & 27%)				2	5	2
\$1,000 - 5,000 (transition)	(8 & 24%)				2	2	4
\$5,000 - 10,000 (transition)	(8 & 24%)			1	1	3	3
> \$10,000 (small)	(8 & 24%)			2		3	3
	(33& 100%)						
Pawn Shop Loans							
- Gold	(9)		2	4	2	1	
- Non- gold	(6)			2	2	2	
Vendor Credits							
- From Vendors	(7)		1	2	1	1	2
- From Others	(5)		1	1			3
Rotating Savings and Credit Assoc. (Latarea)	(6)		1		4		1
Family and friends	(9)			3	2	2	2
Other Loans	(4)				1	1	2
(Specify moneylenders_)							
Agricultural Loans							
Production Loans	(7)				1	3	3
Other Agricultural Loans	(6)					4	2
Other							
Residential Improvement Loans	(6)		2				4
Grant /Loan Type	(6)				1	2	3
Government Credits							
- National	(6)			2		1	3
- International	(5)			1	2	1	1
Total	(115)		7	18	21	31	38
Percent of Total	100%		6	16	18	27	33
Financial Advisory Services				2	2	1	2

TABLE 5A
Non-Bank Respondents' Indication of the Percentage that Demand for Bank Credit Exceeds Supply

		0%	25%	50%	75%	≥100%
Short Term						
Consumer Loans (7)		1	1		2	3
Asset Loans (7)		1	1		3	2
Commodity Loans (5)			2		1	3
Working Capital Loans (7)				2		5
Line of Credit (overdraft) (6)		1				5
Pawnbroker Loans						
- Gold (6)		1	2	1	1	1
- Non-gold (5)		1	1	1		2
Sub-Total Short Term (43)		5	6	4	7	21
Percentage 100%		12%	14%	9%	16%	49%
Longer Term						
Real Estate Loans (5)					2	3
Land Loans (5)		1		1	2	1
Home Improvement (5)			1	1		3
Leasing (5)			1		3	1
Agricultural Loans (5)					3	2
Sub-Total Longer Term (25)		1	2	2	10	10
Percentage 100%		4%	8%	8%	40%	40%
Financial Advisory Services			2	2		1

TABLE 5B

**Bank Respondents Indication of the Percentage that Demand for Bank
Credit Exceeds Supply**

		0%	25%	50%	75%	≥100%
Short Term						
Consumer Loans	(3)		1	1	1	
Asset Loans	(2)			2		
Commodity Loans	(3)			3		
Working Capital Loans	(2)			2		
Loans Line of Credit (overdraft)	(3)		2			1
Pawnbroker Loans	(3)	1	1	1		
Sub Total Short Term	(16)	1	4	9	1	1
Percentage	100%	6	25	56	6	6
Longer Term						
Real Estate Loans	(3)		1		2	
Land Loans	(4)	1	2	1		
Home Improvement	(3)		2	1		
Leasing	(3)	1	1		1	
Agricultural Loans	(3)	1		2		
Sub Total Longer Term	(16)	3	6	4	3	
Percentage	100%	19	38	25	19	
Financial Advisory Services		1		1		

Non-Bank Category Questionnaires

Ninety-four percent of responses regarding non-bank credit (Table 4) revealed unmet demand of at least 25%; i.e. only 6% believed supply to be sufficient to meet demand. Responses were concentrated at the high end of the demand scale, with a full 60% of responses indicating unmet demand of at least 75%. Regarding specific categories, loans from family and friends had high demand. Agricultural loans taken as a whole had the largest number of responses, 13 or 11% indicating unmet demand. All responses were in the 75% or greater demand category except one at 50%. Agricultural loan demand was split slightly in favor of production loans over loans for other agricultural purposes.

Demand for credit from the government through both national and international sources was split nearly evenly; however, taken together, they had the largest number of responses after agriculture and none indicated that supply was adequate to meet demand. There is a clear indication that more is expected of government.

Regarding size of loans, demand was relatively evenly split over the four size categories listed, micro <\$1,000, transition \$1,000 - \$5,000, transition \$5,000-\$10,000 and >\$10,000. A slight preference was indicated toward microloans (27% of size category responses), while each of the other size categories had 24% of the responses.

Sixty-five percent of non-bankers responses regarding demand for short-term bank credit indicated demand was at least 75% more than existing supply (Table 5A). This is close to the 60% in the 75% and above category for non-bank credit. Demand for working capital and line of credit type loans was strongest within the short-term products with 16% and 14% of responses respectively, most of which fell into the category of 100% unmet demand and above. This is a clear indication of the demand for short-term business loans.

Unmet demand for longer-term business loans is even greater, with 80% of responses for longer-term bank credit falling into the category of 75% and above unmet demand. Real estate loans, agricultural loans and leasing were the most popular loan types in the longer-term category. Interviews with borrowers confirmed a strong interest in longer-term credit, especially among agricultural and small business clients.

Bank Category Questionnaires Completed by Bankers

Overall, bankers felt there was less demand for bank credit than non-bankers. Percentage of responses indicating excess demand of 75% and above was 12% for short-term and 19% for longer-term credit. This contrasts with 65% and 80% respectively for those categories from non-banker respondents. This is a dramatic difference and may reflect the bankers' perceptions that it is difficult to locate good clients. Banks have tended to lend to a closed circle of businesses they know rather than court new clients.

Bankers' responses toward financial advisory services were inconclusive; they appear to not regard the services as important. This is in sharp contrast to non-bank respondents who indicated demand exceeded supply of financial services by at least 25% for both bank and non-bank credit

Target Groups for Financial Products

In line with USAID's dual purpose of economic growth and meeting the needs of those groups not served by the existing institutions, part of our market survey focussed on demand by size of loan.

TABLE 6

Non-Bank Respondents Indication of the Percentage that Demand for Credit Exceeds Supply

		0%	25%	50%	75%	≥100%
USD Loans	Nº & % of Responses					
< \$1,000	(micro) (9 & 27%)			2	5	2
\$1,000 - 5,000	(transition) (8 & 24%)			2	2	4
\$5,000 - 10,000	(transition) (8 & 24%)		1	1	3	3
> \$10,000	(small) (8 & 24%)		2		3	3
	(33 & 100%)					
Total	(33)	0	3	5	13	12
Percent of Total	100%	0	9	15	40	36

Three broad categories listed for loans, micro (<\$1,000), transition (\$1,000-\$5,000 and \$5,000-\$10,000) and small (>\$10,000) represent distinct target groups. The below \$1,000 category is mainly the domain of NGOs and applies to both group and individual methodology. The transition loans theoretically represent borrowers who have advanced well through progressively larger loans from NGOs, but are not yet deemed bankable. \$10,000 is a large sum for a borrower. Loans above \$10,000 are frequently better handled by larger, well-managed financial organizations. More sophisticated analyses are required on the larger loans. Agricultural loans as handled by ACDI/VOCA fall primarily within the transition category sizes.

Recommendations

On the basis of the analysis of credit demand information contained in the immediately preceding pages, we propose to USAID the following recommendations.

1. **USAID should increase loan fund capital to organizations that serve private enterprises that are transitioning from lower levels of microfinance to larger loans and provide longer time horizons to achieve self-sufficiency. (These projects would fall under S.O.1.3. See Issue 6). Selection of organizations to receive augmented financial assistance should be done on the basis of an evaluation of their potential for short to mid-range financial or operational sustainability.**
 - The first objective is for microenterprises supported by the initial wave of USAID-financed projects to have continued access to additional credit funds to be able to continue growth.

- The second objective is to enable serious operations that are implementing their projects under best practices methodologies to have the funding basis to achieve financial or operational self-sufficiency. (See Issue 4, Recommendation 2 on sustainability)
- 2. USAID should continue to provide institutional development, technical and financial support to private enterprises and their support institutions, such as is currently being done through the ACDI/VOCA and Shorebank projects.**

ISSUE 3: DEMAND FOR NEW/EXPANSION OF EXISTING PRODUCTS

As an extension of the overall demand questions discussed in Issue 2, USAID asked the assessment team to identify potential new USAID-supported financial products or to identify where to expand the supply of funds for existing ones.

The broad listing of products in the portion of the questionnaire on potential new/expanded products that was sent to USAID non-bank partners and banks, was put forth in light of USAID S.O.1.3's objectives of fueling economic growth and assisting individuals/enterprises outside the existing system. Given our initial information when the questionnaire was developed, we assumed the products were not readily available, if at all, in the existing marketplace.

The objective was to provide information needed by the USAID economic growth program to guide it in determining if and how to expand its coverage and impact, at the SME level particularly. Our expansive listing was not meant to suggest that USAID support each product, but to determine where best it might target its resources. Some products would be much more readily available if difficulties in using land as collateral for business, agricultural and housing loans were resolved.

There were ten questionnaires returned from non-bankers, but only four from bankers. This low bank response may have been due to difficulties in translation and internal assignment of questionnaire completion in the banks. English was the only practical way given the translation time delays. Two of the bank questionnaires were returned with comments in Azeri and translated by our staff.

All non-banker responses came from persons functional in English. Consensus from bankers and non-bankers who were asked prior to sending the questionnaire was that providing it in English only would be appropriate.

Summary of Findings and Analysis

There was a dramatic difference in how non-banks (Table 7A) and banks (Table 7B) viewed demand for potential USAID assisted products. Non-bankers overwhelmingly indicated that there was a very large shortage in supply of credit, with 42% believing that demand exceeded supply by at least 100%. A full 63% believed that demand exceeded supply by 75% or more. Only 9% of bank responses indicated unmet demand of 100% and above. Adding the banker responses at the 75% level (6%) results in only 15% at 75% and above, in marked contrast to the non-bankers opinions. Two percent of non-bank responses indicated no unmet demand, whereas 24% of banker responses fell in this category.

Bankers indicated no unmet demand for products targeted by gender, whereas this was a significant area for non-bankers. The strongest demand categories indicated by non-bankers were production loans, business loans, equipment loans and leasing. All of the responses for these categories indicated there was unmet demand. The Bankers' responses indicated the largest unmet demand was for production and business loans followed by leasing. Neither group was asked to focus on capacity to repay. However, the bankers' knowledge of borrowers' capacity to repay may have influenced their responses by filtering out demand for those with poor capacity to repay. One banker at the participatory session indicated that at least in his bank's case some funds were available for lending. However, they had difficulty in identifying suitable borrowers.

Leasing was listed as a likely third choice followed by equipment loans. Due to the minimal level of legislation in place for leasing, this option might be left for a later time. Clearly there is sufficient demand for production and business loans to justify working with them through both banks and non-banks.

Recommendations

On the basis of our analyses of the data, it is clear that the following types of loans have a large unmet demand. In the opinion of the assessment team, while almost any kind of credit, except pawn loans, has high unmet demand, the loan products prioritized below are also loans that have the greatest economic growth impact potential in terms of creating jobs and income. Job creation and income generation are two criteria, which should be given the highest priority for any expanded or new loan products or vehicles to be recommended to USAID under the current difficult economic situation in Azerbaijan.

Furthermore, given the current legal and regulatory environment and the rather elemental, but crucial, constraints placed on formal banks and NBFIs (see Issue 1), it is our opinion that emphasis should be placed on expanding access to the kinds of credit listed below, rather than concentrating on more esoteric kinds of financial products that would require lengthy processes for becoming legalized in the current system.

Thus, in making our recommendations, the assessment team took into consideration the practicality of various products. We considered the kinds of products that are in great need and could be expanded or brought on stream relatively quickly considering the legal and regulatory environment. We are concerned about the time sensitivity of the different products as well as their demand.

TABLE 7A

**Non-Bank Respondents Indication of the Percentage that Demand
for Credit Exceeds Supply**

		0%	25%	50%	75%	≥100
Possible USAID Assisted Products						
Equipment Loans	(7)		2		2	3
Equipment Leasing	(6)		1		1	4
Real Estate Purchase	(7)	1	1	1		4
Building Improvement	(2)		1		1	
- Residential	(5)		1		1	3
- Commercial	(5)		1		1	3
Leasehold Improvements	(7)		3		1	3
Land Purchase	(6)	1		2	1	2
Lease Purchase	(6)		3		1	2
Production Loans	(7)			1	2	4
Business Loans	(8)			2	3	3
Loan Products:						
- Targeted to Women	(8)		2	3	1	2
- Targeted to Men	(7)			3	1	3
Other Products – Loan /Non-loan	(5)			3	2	
Total	(86)	2	15	15	18	36
Percentage	100%	2	17	15	21	42

TABLE 7B

Bank Respondents' Indication of Percentage that Demand for Credit Exceeds Supply

		0%	25%	50%	75%	≥100
Possible USAID Assisted Products						
Equipment Loans	(3)		1	1		1
Equipment Leasing	(4)		3		1	
Real Estate Purchase	(2)		1		1	
Building Improvement						
- Residential	(4)	1	2	1		
- Commercial	(1)			1		
Leasehold Improvements	(3)	1	2			
Land Purchase	(3)	1	1	1		
Lease Purchase	(2)	1				1
Production Loans	(4)			3		1
Business Loans	(4)			4		
Loan Products:						
- Targeted to Women	(2)	2				
- Targeted to Men	(2)	2				
Total	(34)	8	10	11	2	3
Percentage	100%	24	29	32	6	9

We recognize that above the microlevel, the preponderance of loans (in terms of volume) will have loan terms of more than one year and often will have intermediate terms of up to five years. These larger, SME targeted loans would require reasonable cash flow expectations to cover debt service and loan repayments. They will also require more loan analysis and servicing than microloans because of the uncertainties and inherent risks of lending larger amounts with longer terms often under individual lending methodologies that will, in turn, require physical collateral. (These kinds of interventions would be under S.O.1.3. See Issue 6 discussion and Recommendations 2 and 3 for additional thoughts on Strategic Complementarity.)

Taking into consideration the above criteria and practicalities, the team makes the following recommendations.

- 1. USAID should adopt, fund, and implement an expanded business loan program for use by selected NGOs (see Issue 2, Recommendation 1) and privately-owned commercial banks. It should concentrate in the short-term on expanding funding of microloans and individual SME loans in the US\$2,000 to US\$10,000 range.**

The loan priority areas should be:

- Loans for production -- operating, inventory, working capital
- Loans for fixed assets -- machinery, equipment, building repairs, building improvements
- Loans for transportation -- vehicles, equipment

These loans help create jobs and income, and, as mentioned earlier, they deserve a higher priority than loans to individuals for their residences or leasehold improvement, to give two examples. A separate lending program would be needed for individual housing, primarily home improvement and leasehold improvements. But, the team recommends USAID focus initially on the above bulleted loan priority areas.

- 2. USAID should encourage its U.S. and other bilateral private sector partners/collaborators to make concerted efforts to influence the Government of Azerbaijan to develop and implement legislation that will allow leasing operations to be instituted.**

ISSUE 4: STRENGTHS WEAKNESSES, OPPORTUNITIES AND THREATS (SWOT) REGARDING EXISTING USAID PARTNERS

To deal with the financial institution and its efficiency in reaching its (and USAID's) target markets, we asked for a SWOT analysis from each of the institutions with which USAID is now affiliated. This question was designed to lead into the broader question of sustainability. The categories used were:

- Sustainability
- Governance
- Internal Controls
- Products
- Market Position

TABLE 8A

**Issues Related to Strengths and Weaknesses of USAID-funded
Non-Bank Credit Institutions (Respondents' Comments)**

Topic	CredAgro (ACDI/VOCA)	ADRA	FINCA
Sustainability:			
<i>Strengths</i>	Nationwide exposure Skilled staff High repayment rate Sound portfolio TA assistance/Extension	Proven methodology, systems, policy, procedures and products. Motivated credit supervisors and officers	Product design for profitability.
<i>Weaknesses</i>	Young organization with ambitious task	Insufficient loan fund capitalization	Difficulty developing staff, particularly for client interface
Governance:			
<i>Strengths</i>	Initial strong centralized system based on incentives with transition plans for decentralization. Good communication with branches.	Board already in place	FINCA resources outside Azerbaijan for support.
<i>Weaknesses</i>	Board needs to be established and developed	Board lacks experience in financial management or governance	Difficulty developing a strong board with ownership
Internal Controls:			
<i>Strengths</i>	Monitoring & evaluation Portfolio tracking system Results oriented	Learned lessons and adapted controls accordingly	Internal audit department Regional team leaders & inaugurators with audit/inspection function
<i>Weaknesses</i>	New system requiring fine tuning	Implementing environment does not consistently reward honesty/integrity	
Products:			
<i>Strengths</i>	Competitive terms Individualized products based on sound business planning	Demand driven Priced for sustainability	Market driven
<i>Weaknesses</i>	None identified	Concentration on agriculture	Inflexible repayment schedule
Market Position:			
<i>Strengths</i>	Coverage in a number of regions Leader in small (\$5-6 K) loans	Reputation for high integrity Regional coverage and outreach	Credit leader
<i>Weaknesses</i>	Need more coverage in key regions	Small loan fund	Credit only posture means no referrals from other business areas of organization

TABLE 8 B:

**Issues Related to Strengths and Weaknesses of USAID-funded Non-Bank Credit
Institutions (Respondents' Comments) (Continued)**

Topic	Save the Children	Shore Overseas Az.	World Vision
Sustainability:			
Strengths	Low cost structure, competitive rates	High demand Operationally sustainable	Driven by international standards
Weaknesses	Uncertainty over ownership of loan capital Dependence on grant capital and foreign management	Could improve loan processing efficiency	Undercapitalized
Governance:			
Strengths	TA and support	N/A	Board under formation Strong senior and middle management
Weaknesses	No board established	N/A	Need to be registered
Internal Controls:			
Strengths	Full-time compliance officer Zero corruption policy	Outside attorney reviews documents	Strong policies and procedures Full time internal auditor
Weaknesses	Corruption is normal in the environment	Small staff requiring country manager to be primary controller	MIS (will be corrected with new system by year end)
Products:			
Strengths	Group loans tailored for the market	Good coverage of \$1,000 - \$50,000 range	Flexible terms
Weaknesses	Limited variety Limited product flexibility	Loan under \$10,000 are nearly overpriced	Difficult to work with clients lacking collateral
Market Position:			
Strengths	Dominant in some geographic areas Lots of repeat business	Receptive to new customers	Long term relationship with clients
Weaknesses	Shortage of loan capital be able to adequately serve the market Shortage of experience in some of the diversified products like agriculture.	Some customers regard processing time and requirements as a negative	Can't meet the demand

TABLE 9A

**Issues Related to Opportunities and Threats Facing USAID-Funded Non-Bank
Credit Institutions (Respondents' Comments)**

Topic	CredAgro (ACDI/VOCA)	ADRA	FINCA
Sustainability: Opportunities	Transformation to sustainable agricultural finance system	High demand in service area with little competition	High potential growth market
Threats	Discontinuation of financial support before the transformation process is completed	Wide geographic disbursal of potential clients	Taxation Competition with unsustainable products offered by others
Governance: Opportunities	Strong independent branches envisioned	Experienced board	
Threats	Several years of intense management training required	Board's experience is in humanitarian area	Lack of good governance experience in the country
Internal Controls: Opportunities	Strong incentives to attract the best people	Loan tracking system	New awareness in Azerbaijan of the need for internal controls
Threats		Corruptible staff may infiltrate the program	Need for internal control and checks can overshadow the rest of the program
Products: Opportunities	Diversification	Recently privatized land skilled agriculturists	Product expansion Larger size loans
Threats	Competition	Agricultural loans higher risk	Not offering grace period Competing with grants and subsidized loans
Market Position: Opportunities	Will be a market leader in short run	High demand Little competition	Cover strong credit regions
Threats	Increased competition in the long run	World Bank credit union initiative	Press attacks on NGOs

TABLE 9B

Issues Related to Opportunities and Threats facing USAID-funded Non-Bank Credit Institutions (Respondents' Comments) (No comments for Shorebank Overseas)
(Continued)

Topic	Save the Children	World Vision
Sustainability:		
<i>Opportunities</i>	Large demand Small credit supply	Reach sustainability with minimum capital
<i>Threats</i>	Potential government interference Subsidized credit	Economic and social conditions may deteriorate
Governance:		
<i>Opportunities</i>	Develop effective board during current project	Attract those with good reputations and interest in helping the country
<i>Threats</i>	Difficult finding and training qualified board members	Change in control over assets
Internal Controls:		
<i>Opportunities</i>	Transparency	Prevention
<i>Threats</i>	Collusion among staff and clients	Fraud
Products:		
<i>Opportunities</i>	Demand for different loan types	Create new products for specific needs
<i>Threats</i>	Higher risk and perhaps less profitability than trade	More complexity
Market Position:		
<i>Opportunities</i>	Expansion	Credit combined with business development services
<i>Threats</i>	Additional funds required for expansion	More institutional infrastructure needed

TABLE 10

**Issues Related to Strengths and Weaknesses of USAID-Assisted Banks
(Respondents' comments)**

Topic	Rabita Bank	AzeriGaz Bank
Sustainability:		
<i>Strengths</i>	Wealthy Chairman who could likely bail out the bank.	Wealthy Chairman who could likely bail out the bank.
<i>Weaknesses</i>	Not strong financially, only 1-2 credit officers.	Not strong financially, only 1-2 credit officers.
Governance:		
<i>Strengths</i>	See below. This situation has been changing recently.	During SME project, the credit committee showed some independence. Credit officers slightly more competent than Rabita's.
<i>Weaknesses</i>	Chairman makes all decisions, including who to fund. Credit committee has been very weak.	Dominance by the Chairman
Internal Controls:		
<i>Strengths</i>	Decision-making is relatively transparent.	Seems to monitor its loans better than Rabita.
<i>Weaknesses</i>	Tracking and monitoring loans.	Decision-making lacks transparency.
Products:		
<i>Strengths</i>	Pawn service.	Most willing of three banks to make loans during SME project.
<i>Weaknesses</i>	Before and after program, products are limited to very short-term loans (3-6 months). Lending limited to well-known clients. Not ready to make loans to unknown SMEs	Before and after program, products are limited to very short-term loans (3-6 months). Lending limited to well-known clients. Not ready to make loans to unknown SMEs
Market Position:		
<i>Strengths</i>		
<i>Weaknesses</i>	Very limited market share (about 1-1.5%) Overshadowed by International Bank of Azerbaijan.	Very limited market share (about 1-1.5%) Overshadowed by International Bank of Azerbaijan.
Other:		
<i>Strengths</i>		Most interested of three banks in receiving training.
<i>Weaknesses</i>		Sometimes subordinates loans to other interests of Chairman.

TABLE 11

**Issues Related To Opportunities And Threats Facing USAID-Assisted Banks
(Respondents' Comments)**

Topic	Rabita Bank	AzeriGaz Bank
Sustainability: <i>Opportunities</i>	Increased number of depositors because Shorebank's direct lending project is based in the bank.	
<i>Threats</i>		
Governance: <i>Opportunities</i>	Formally established credit committee. Problem loan workout group.	Formally established credit committee. Problem loan workout group. Requesting training from Citizen's Democracy Corps in such areas as marketing, organization.
<i>Threats</i>		
Internal Controls: <i>Opportunities</i>	Has Shorebank methodology, and can use it if they want to.	Has Shorebank methodology, and can use it if they want to.
<i>Threats</i>		
Products: <i>Opportunities</i>	Expect bank to be more willing to make loans to walk in clients after SME project.	Expect bank to be more willing to make loans to walk in clients after SME project.
<i>Threats</i>		
Market Position: <i>Opportunities</i>	Interested in expanding range of loan products, including real estate loans.	Interested in expanding range of loan products, including real estate loans.
<i>Threats</i>		

Summary of Findings and Analysis

Banks differed significantly from the non-banks in the analysis. The analysis of the banks was performed by Shorebank Advisory Services and may not necessarily reflect the feelings of management of the individual banks. Although the team interviewed bank clients and credit officers, time did not permit detailed visits with bank management. The team's sense, which was verified by the feelings of the IFC Representative, was that the banks mentioned in Tables 10 and 11 above and other banks were indeed interested in small-scale lending.

Non-Banks:

Regarding sustainability, all organizations recognized the overriding importance of achieving sustainability. A common theme in comments about sustainability was capitalization. There were concerns that the amount of capital available for loan funds was insufficient. Despite strong demand, lack of sufficient capital to achieve reasonable scale will impede achieving sustainability.

On the issue of governance, clearly the TA providers are presently in charge. The real challenge in several cases is to establish boards, in other cases it is to develop boards. The past command system was not a training ground for meaningful experience in governance. This area is a real challenge as it will take time to develop good governance discipline. Without well-developed governance, all other issues surrounding sustainability will make little difference in the long run.

Internal control is another issue, which organizations are working hard to develop and fine-tune. Internal control presents a constant challenge in an environment where corruption seems to be the norm. Project managers were frank about past cases of staff corruption. The providers recognized these weaknesses and are working with a zero tolerance for corruption. Several borrowers mentioned their appreciation at not being solicited for bribes by staff when obtaining loans through USAID-sponsored programs. More time is required to fully develop internal controls and to insure their effective operation.

Products currently offered are relatively simple and cannot come close to meeting demand with present levels of loan capital. Borrowers expressed desire for larger loans and longer terms. Availability of loan capital inhibits offering these types of products. The capital issue is more pressing than the product issue.

Market position, similar to products is constrained by availability of loan capital. Each of the programs has carved out special markets either geographically or in client niches; however, future growth will depend on access by the programs to additional loan capital.

Banks:

Banks in general are very weak in Azerbaijan, with small amounts of capital and a smaller amount of deposits. There are clear sustainability concerns for the two banks that participated with ShoreBank Advisory Services and IFC in the SME Finance Program. It appears some other banks may be stronger financially based on Banker Association reports. Both SME Finance Program banks and other banks present in the participatory session expressed interest in obtaining technical assistance and loan capital. Comments about the banks reflect profiles of

organizations dominated by their chairmen and with limited market share due to dominance of the International Bank of Azerbaijan (which is scheduled for partial privatization). The treatment that has been selected for the banks is one of workout rather than engaging them in furthering their abilities. Provided banks are willing to accept TA and manage loan funds as prescribed by project agreements, there may be opportunities to move them toward market-oriented lending.

Recommendations

- 1. USAID should provide TA support in the areas of governance and internal controls.**
- 2. USAID should implement longer-term project horizons considering that the transition from a command economy mentality cannot occur in a few years.**
- 3. Additional loan capital should be made available to programs demonstrating viable plans for scaling up to achieve sustainability.**
- 4. Opportunities for working with the banking sector should remain open, even within the confines of Section 907. Even exposure of the bankers to the present successful non-bank credit programs could be helpful in orienting the banks to more market based operations.**

ISSUE 5: POTENTIAL FOR THE SUSTAINABILITY OF MICROFINANCE INSTITUTIONS

After analyzing the basic strengths and weaknesses of the institutions, we dealt with the question of institutional viability and what will last over the long term. The question is essential in terms of USAID's own strategy and current focus. Resources – time and money – are scarce. USAID must allocate them among the projects led by institutions that will be able to carry them on after USAID has completed its current mission.

Donors tend to provide two very expensive things: funds and management. Evaluations tend only to look at replacement funding when discussing sustainability. However, financial institutions are made or broken by keeping their overhead low. The most expensive portion of their overhead is salary. With that in mind, we asked questions regarding sustainability in the following categories, and in the following order:

- Management
- Personnel
- Checks and Balances
- Market
- Funding

TABLE 12A
**Microfinance Institutions Self Rating of their Levels of Operational
and Financial Sustainability**

Please rate each according to the following categories:	Inadequate	Adequate	More than Adequate
Operational Sustainability:			
a. Management Issues:			
Transition from T/A to local (8)	3	5	
Management succession (8)	2	6	
Independence of local management from local pressures (9)	4	4	1
Adequacy of compensation of local managers (9)	1	7	1
Sub- Total (34)	10	22	2
Percentage 100%	29	65	6
b. Personnel Issues			
Training (9)	2	6	1
Organizational structure (8)		7	1
Sub-Total (17)	2	13	2
Percentage 100%	12	76	12
c. Checks and Balances			
Policies (9)	1	6	2
Procedures (9)		7	2
Internal controls (9)		8	1
Sub-Total (27)	1	21	5
Percentage 100%	4	78	18
d. Market Issues			
Pricing of products (9)	3	4	2
Size of market (9)	3	4	2
Expansion of products and geographic area (9)	5	3	1
Sub-Total (27)	11	11	5
Percentage 100%	41	41	19
Financial Sustainability: (Note: In addition to operating sustainability issues, the following are necessary)			
a. Original funding (8)		6	2
b. Uninterrupted on-going funding (7)	2	3	2
c. Diversification of funding sources (7)	4	3	
Sub-Total (22)	6	12	4
Percentage 100%	27	55	18

TABLE 12B**Rating of Present Level of Sustainability of Respondent's Institution**

Category	0-25%	26-50%	51-75%	76-100%	>100%
Operational	2		2	2	1
Financial	1		3	1	

TABLE 12C**Projected Level of Sustainability of Respondent's Institution**

Year	Category	0-25%	26-50%	51-75%	76-100%	>100%
Year 1	Operational		1	1	3	1
	Financial		1	2	1	
Year 2	Operational			1	2	2
	Financial			1	3	
Year 3	Operational				3	2
	Financial				3	1

Summary of Findings and Analysis

Sustainability issues were only addressed at the non-bank institutions as support to the two remaining banks under the SME program is in a state of suspension. Shorebank Advisory Services had concerns about the cooperation and financial strength of the banks. Accordingly, IFC withheld further tranches of loan funds. Shorebank has decided to discontinue operations in Azerbaijan when its present contract expires in September 2002.

Six institutions provided information on this issue in varying degrees of completeness. The responses showed there is a great deal of variation in the level of financial and operational sustainability (Table 12B). Much of the variation is due to the length of time the programs have been in operation, with some beginning lending only in mid-2001. One response indicated operational sustainability at present exceeding 100%, two were in the 76-100% category but two were in the less than 25% category. Most of the responses on the present state of financial sustainability fell in the 51-75% category, with one under 25% and one in the 76-100% category. This response, which was the highest rating for financial sustainability did not include overhead costs from headquarters in the calculations. Including those costs would likely have placed it in the next lower sustainability category. There are clearly some excellent financial records kept by the organizations, but it appears that more consistency is required in reporting sustainability statistics to allow more accurate comparison between programs. Sustainability projections appeared to be rather optimistic, with all responses indicating achievement of at least 76% operational and financial sustainability within three years. Use of planning software such as MicroFin would aid programs in planning for sustainability and help achieve more comparable statistics across programs.

Regarding specific issues impacting sustainability, market issues, management issues and funding issues had the greatest percentage of responses indicating inadequacies. A full 41% of

responses related to market issues (pricing of products, size of market, product and geographic expansion) indicated inadequacies. Within these issues, product and geographic expansion were rated lowest. This may be due to past funding restrictions many donors tied to working with IDPs. Twenty-nine percent of responses on management issues indicated inadequacies. Independence of local management from local pressures was rated as weakest among the four management issues (transition from TA to locals, management succession, independence from local pressures, adequacy of compensation). Regarding Funding issues (original funding, uninterrupted ongoing funding, diversification of sources), 27% of those responses indicated inadequacies. Original funding was not an issue. Diversification of sources received the most responses for inadequacies in the funding category. This may be explained by the fact that all respondents were existing programs and were therefore past the original funding hurdle. The Team found concerns for uninterrupted on-going funding and diversification to be significant issues during field visits. Additionally, most of the TA contracts expire in less than two years, which may place additional stress on attaining sustainability.

The categories where responses showed the greatest percentages of adequate and better were for: checks and balances, 96%; personnel issues, 88%; and funding, 73%. This indicated satisfaction with policies, procedures, internal controls, training and organizational structure.

The Team noticed that organizations generally had policies and procedures readily available for their staffs' use. Responses related to funding need to be considered in light of the fact that the favorable rating on the original funding issue heavily skewed the funding category. Without the favorable impact of that rating, the funding category would rate only 36% adequate or better. Based on the questionnaire responses, future funding may, in fact, be the largest challenge facing the organizations in the future from the standpoint of sustainability.

Recommendations

The first recommendation here also largely reflects Issue 2, Recommendation 1. None-the-less it is pertinent here and merits repetition in the context of institutional viability issues.

- 1. USAID should encourage increased scope of operations among present institutions by increasing loan fund capital to organizations and providing longer time horizons to achieve self-sufficiency. Selection of organizations to receive augmented financial assistance should be done on the basis of an evaluation of their potential for short to mid-range financial or operational sustainability.**
- 2. USAID should encourage adoption of a uniform tool to project and calculate measures of sustainability. MicroFin is an example that would also allow for uniform planning and reporting.**

ISSUE 6: TRANSITION FROM HUMANITARIAN RELIEF TO ENTERPRISE DEVELOPMENT CREDIT

Finally, the Scope of Work asked the team to review the S.O. 1.3 and S.O. 3.0 portfolios to determine where more strategic complementarity is possible in the future. USAID is interested in assuring that all the institutions conducting projects under both S.O. 1.3 and S.O. 3.1, alike, be

included in the sustainability equation, and that as many markets as practical be served by them in the course of their institutional development in Azerbaijan.

ACDI/VOCA, Shorebank and FINCA presently have credit programs funded under S.O. 1.3. Credit programs funded under S.O. 3.1 include ADRA, World Vision, Save the Children, and the International Rescue Committee (IRC). The Team interviewed management and staff of each of these organizations both at the headquarters and the field level. Additionally, site visit interviews were conducted for at least two borrowers from each of the organizations.

As USAID credit projects began to shift from a humanitarian assistance to a longer-term development focus, and, as they began dealing with a broader spectrum of Azerbaijani businesses, the discussion of which S.O., humanitarian assistance S.O.3.1 or economic growth S.O.1.3, should oversee these projects, came increasingly into focus.

Summary of Findings and Analysis

It appears to the assessment team that the S.O.1.3 portfolio, was established with the intent of becoming sustainable. The projects encompassed under this S.O. were funded with more loan capital and support for TA. The S.O. 3.1 based projects, on the other hand, were established with the intent to provide assistance quickly to a specific target population and were not created, necessarily, from the outset with sustainability objectives. Concentration on IDPs slowed growth toward sustainability as projects could not scale up as they otherwise would when operational sustainability over a specified time period is an objective. The desire to initially deliver finance quickly to the IDP target population, likely diminished the overall emphasis in the portfolio on sustainability.

Therefore, while both portfolios are currently looking toward sustainability (or getting out of the credit business, as in the case of the IRC), the S.O. 3.1 portfolio had less resources available for loan capital. Coupled with the early directives to concentrate on IDPs and short time horizons within which to achieve sustainability, this portfolio had difficult obstacles to achieving the necessary scale.

Notwithstanding, the team found that both current portfolios were utilizing, or at least aware of “best practices” technology. There was awareness of the importance of attaining sustainability in USAID credit programs generally. Borrowers under the ACDI/VOCA and Shorebank programs had larger loans as there is a different focus than the other programs. In all cases, borrowers have been genuinely helped by the loans.

The S.O.3.1 based NGOs all have multiple social services that they provide to their clients and their credit operations are an extension of these, often servicing the same people who receive the other social benefits offered. On the other hand, S.O.1.3 partners are specifically focussed on their credit and financial sector work. Thus, there is a significant difference in the types of implementing organizations under each S.O. To try to split off the existing microcredit functions of one of these humanitarian relief focussed organizations, might be counter productive.

It does not seem to be required or necessary to create a separate operation for the credit aspects of the present S.O. 3.1 projects to fit into the S.O.1.3 strategic area. It would suffice to create clearly identifiable and hopefully sustainable cost centers for the credit components within each

S.O.3.1 NGO while keeping them united under their compatible social and humanitarian institutional emphasis. Present projects which cannot reasonably expect to reach sustainability should consider cooperating with an existing larger credit provider. However, new financial sector projects or expanded projects, with larger loan limits and longer terms, clearly focussed on economic growth, should be created under S.O.1.3. from the outset and would work with larger and more established enterprises. (See Issue 2, Recommendation 1).

Recommendations

- 1. USAID should expand its funding of credit, training, and technical assistance to established microfinance projects currently under S.O.3.1 and S.O.1.3., respectively.**
- 2. USAID should continue to assign projects working primarily with IDPs, having underlying social and humanitarian objectives, under S.O.3.1. Those with a clear operational bent toward economic growth and sustainability goals, would continue under S.O.1.3, eg. maintain the status quo.**

USAID should assign new projects having clearly enterprise and economic growth objectives under S.O.1.3. New financial products would be developed under the aegis of these projects. (See Issue 3, Recommendation 1)

SUMMARY & CONCLUSIONS

Azerbaijan was unable to enjoy a private sector economy for about seventy years. During that time, little development occurred and the Soviet financed and utilized industries became obsolete and are now closed. Most commercial activities are in five cities with few manufacturing firms, so the economy is based on agriculture, trading and services. Except for considerable imports from Turkey, China and the North, the people continue to be self-sufficient at a minimum level. Unlike Georgia, the semi-arid climate prevents the reliance on “private plots” (yard of home). The prior poor management of sizeable acres of farming land is evident by broken irrigation systems, inconsistent cropping patterns, obsolete equipment, and dated seeds of crops and breeds of livestock.

Microloans were introduced from similar countries just over three years ago. The actual use of microloans is relatively recent. Most of the microloans have a four-month maturity with the expectation of repayment and reapplication for the issue of an additional US\$50 for four or more times. Based on this limited period of time for microloan activity and with a fairly stable economy at the local level, the capacity to continue to repay his/her debt has not been fully tested. Women are actively selling in the markets and shops, so the target loans are getting to them as well as others.

Lack of customer confidence in the Manat and in the commercial banks continues. A proposed microfinance bank funded by international investors like IFC will target the SMEs, and to a lesser degree, the microloan area. In order to reduce the cost and improve efficiency, the country would be better served with only five or six strong branch banks that could cover the five or so major cities and regions. This should leave room for local start-up banks and other financial institutions to become competitive with the existing branch banks.

With deposit insurance and a stronger national bank (Central Bank), the better-capitalized commercial banks could commence a type of commercial paper with a longer maturity than the existing Treasuries (three months). This commercial paper should be issued in Manat. Commercial paper is a natural forerunner to the securities market. IFC has the tools and the current lending experience in Azerbaijan to provide needed technical assistance to banks. This could begin the substitution of near total reliance on Donor Funds and of uncertain amounts. This would also be an ideal source of lower cost funds for consumer loans, production loans, residential improvement loans and equipment leasing loans.

The team did not find substantial differences in the borrower activities of the Humanitarian Relief Loans, when compared to other microcredit loans. If and when funding by these institutions are concluded, the existing unpaid loan portfolio can be transferred to another responsible entity, which can collect the principal and interest and return any principal to the original lending organization. This represents the sale of assets based on future cash flow and with “full recourse” to the original lender. The transfer and re-employment of loan supervisors should be encouraged, but the ratio of loans outstanding to loan supervisors needs improvement and should be negotiated into the transfer.

In sum, the team reached the following conclusions regarding microfinance:

- Given the immediate short-term objectives of USAID and other donors to alleviate human suffering by assisting microentrepreneurs to create employment and generate income, the notion of using the microfinance tools to reach IDPs and others who fit the microenterprise definition, was a logical, well chosen implementation strategy.
- Based on the limited period of time that the projects have been operating and given a fairly stable domestic economic situation, repayment rates have, so far, been good. But the capacity to repay under more difficult circumstances has not been really tested.
- Technical assistance and training for NGOs appears to have been effective. NGO microfinance projects supported by USAID show a high level of sophistication in the use of “best practices” techniques in the management and implementation of their projects.
- Prospects for the sustainability is limited for most microfinance organizations, in large part, by the limited volume of the loan funds and the time period assigned within which to achieve this objective. With a combination of more funds, a slightly longer time horizon, and limited amounts of technical assistance, the USAID-financed NGOs should be able to achieve at least operational self-sufficiency in the near term.
- There is a major lack of confidence throughout the country in the banking system and with the shallow amount of microcredit availability, the team believes USAID and other donors will need to continue injections of loan capital for the development of MSMEs for at least three to four years. This will allow time for actions to occur which build confidence in the financial community which will, in turn, motivate people to put their own funds to work in a business or deposit for other investors to use.

Finally, the team can confirm that the entrepreneurial spirit is alive and well throughout Azerbaijan even with the availability of only a minimum of resources. However, to help achieve a firm basis of market orientation among small and medium scale enterprises, additional basic, practical business training is needed at the level of individual enterprises in addition to the financial intermediaries.

ATTACHMENT 1

SELECTED BORROWER CASE STUDIES

**CASE #1: EXAMPLE OF LOAN TO INTERNALLY DISPLACED PEOPLE (IDP)
VILLAGE OF KUCHARLI (TAR TAR): SAVE THE CHILDREN
(BARDA) SOLIDARITY GROUP GUARANTEE**

- Group of 24 members originally from Agdam in the occupied area.
- Different kinds businesses represented in the group.
- Nine farmers in the farming section of the group.
- Truck farming is the principal activity.
- Third cycle currently: 850,000 Manats per member at 4.5% per month on a declining balance. First cycle: 450,000 Manats per member; Second cycle: 650,000 Mantas per member.

The Kucharli Group is located approximately 25 km. outside the city of Barda in the Central Region in the so-called IDP belt, where many IDPs have tried to re-establish their lives. The group members have different kinds of businesses. Some sell spare auto parts, others have miscellaneous shops, others produce and sell agricultural produce from roadside stands.

We spoke with a member of the truck sub-group specifically. Group members produce cucumber, tomato, eggplant, corn, coriander, and carrots. Some production is for personal consumption and the balance for income generation. The fact that there are nine truck farmers in the group has not created a competitive problem for the member interviewed. The other members are not “hurting” his sales, as “There is large demand.”

The loan proceeds have been used to purchase seed and fertilizer (mostly manure) for land preparation.

Because of the loans, group members have not only been able to plant in their own small plots for personal consumption, but have expanded and diversified their production to generate increased family income.

While they are very glad to have access to credit, the group spokesperson stated that for this kind of agricultural lending, loan terms should be adjusted. It is very hard for the group members to pay off agricultural loans in four equal monthly installments. Their request is to lengthen the repayment period and to be able to pay in a single payment upon liquidation of the crop, reflecting the cycle of any given crop. They would also like to see an increase in the maximum loan amounts.

CASE #2: EXAMPLE OF INDIVIDUAL LOAN: WORLD VISION SMALL SCALE ENTERPRISE (SSE); BAKU

- Garment Business (These two cousins work together out of two locations.
- Loans taken: US\$17,000 (3 microloans of US\$1,500 and 2 loans of US\$5,000 and US\$7,500 respectively (Sabir) using apartment as collateral;
US\$6,000 (4 loans of US\$1,500 and will go for a fifth loan of US\$1,500)
(Hosrov)
- Total: US\$23,000 (all first loans paid off and current loans on schedule)

We visited the shop in an apartment complex in Baku that was rented from the State by Sabir. Sabir is more the administrator/manager of the business, while Hosrov is the technical/production person. The family is originally from Latchin but came to Baku years ago before the 1988 conflict. Hosrov has been in the garment business, first as a tailor, and now, as a shop owner, for a total of 14 years. His cousin, Sabir, got into the business six years ago.

Hosrov first learned of World Vision from posters on the walls of their complex. Even though Hosrov and Sabir are not IDPs, there were many congregated at the complex, and, for this reason, World Vision was advertising there. Hosrov took out his first of four loans for \$1,500, putting up his machinery as collateral. He used the loan to purchase some additional used and new machinery. Then, in 1997, Sabir took out his first loan of three, using it for expansion and investment in capital equipment. Little by little, jointly the two cousins have grown their business to the point that they now have 58 employees between them (Sabir, 41 and Hosrov, 17). The first loans were used to build production capacity, which they have done. They quadrupled capacity using the loans from World Vision. Sabir's last loan was for US\$7,500 and was used to purchase raw materials, which has been a bottleneck.

Their situation is that they have good production capacity to supply buyers in Moscow, but need to finance larger amounts of raw materials. Sabir would like to double his last loan and take out a larger, US\$15,000 loan for raw materials. He has inquired at several private banks, but, as reported, the banks want extra, under the table fees for their services. The additional costs of these extra-legal charges, plus notary charges to register collateral, make bank borrowing too expensive. Hosrov would also like to take out larger loans, but doesn't own an apartment, so he is pretty much held, under World Vision rules, to the microloan maximum level of US\$1,500. These entrepreneurs need a different financial product to help them to keep growing their company. They either need to find this product in another organization or World Vision might consider developing one.

As the USAID assisted MSE program matures, more of these cases will be seen, as USAID-financed borrowers grow. Without the IFC facility or something like it, that might be termed a "bridging" loan, budding businesses and true entrepreneurship will be stopped in their tracks.

CASE #3 EXAMPLE OF INDIVIDUAL LOAN: IFC/SHOREBANK MID-SIZED COMPANY; BAKU

Printing Press

IFC/Azerigazbank with Shorebank assistance earlier in the program

Total loans: US\$57,000; Outstanding balance: US\$22,000

Monthly payment: US\$1,833

This business began in 1990 with three people and one small press. Over the years it gradually expanded, but the business was still rudimentary and, by the owner's own admission, the quality of his product was not very good. His only source of credit at that time was from suppliers, who gave him credit of US\$2,000 to \$3,000 up to a month to pay.

The owner has taken three loans from the Azerigazbank with IFC backing for \$27,000, \$10,000, and \$20,000 over the past several years. The interest rate is 23% and his outstanding balance is currently \$22,000. He pays \$1,833 per month.

He used the initial loans to purchase new and used equipment that was more efficient and could produce higher quality output than he had. He also financed a move in business location to give him a larger space. He believes he has increased his quality by having better equipment. This enables him to compete better with the other 130 print shops in Baku. He thinks he is now within the top ten. When he took the loans his business had 13 employees. He now has 30 employees.

He roughly calculated a profit (he needed our help) of 11% of gross sales. Subtracting the cost of capital (principal and interest payments), he calculated a net profit margin of 5% on gross sales of US\$44,000 per month. We are certain these figures are not accurate, but the telling story is that he and his personnel need training in the financial area to do these calculations. Notwithstanding, he has a good business and is taking advantage of his loans.

He now wants a larger loan amount of about \$42,000 to be able to get highly automated German equipment to further increase efficiency and use fewer full-time workers. The equipment actually costs about \$50,000, but he would be able to put up about US\$8,000 of the cost. Since he is a client, he could get a loan from the Azerigazbank at 25% interest per annum. (Those who are not known by the bank would be charged at least 30%, according to the Azerigazbank loan officer who accompanied us.) The notary fee would be about 3% of the balance. No other hidden charges were mentioned. When asked if he could handle the US\$2,600 monthly payment, he replied that he could.

Our impression is that this was a successful loan and is indicative of a loan product that is one that USAID might consider promoting and, possibly, supporting in the future. It enabled the company to grow, increase quality and efficiency, expand output, and employ 17 more people.

CASE #4 EXAMPLE OF INDIVIDUAL LOAN: ACDI/VOCA CREDAGRO

Diversified Agricultural Producer: Wheat seed, sheep fattening, apiary, equipment repair
Sharabkhanli Village, Jalilabad Rayon

The interviewee jointly operates the farm with three brothers and other collaborators. He is an innovator and clearly the driving force behind the operation. He began operations in 1991 from privatization of 50 Hectares (HA) and worked with one brother. At that time each person could receive 25 HA under privatization. Other brothers joined in 1993 and 1995, each bringing in an additional 25 HA. However, it seems that privatized land in his area was retroactively limited to 15 HA per person. Presently the brothers own 60 HA and operate another 45 on various arrangements. There are some innovative arrangements. Besides renting 15 HA, they jointly farm 15 HA with another owner. A third owner asked them to share crop 15 HA. This illustrates the variety of options available to both landowners wishing to rent out their land and farmers wishing to increase the size of their operations.

The primary enterprise is wheat for seed (7-10 varieties), with some sheep fattening (120 sheep), apiary (100 hives) and machinery repair as ancillary enterprises. During the harvesting season, the farmstead doubles as a service center for combines on surrounding wheat farms. He has a welder and some tools.

CredAgro extended an \$8,000 loan to the borrower on May 2, 2001. He was pleased that the loan was obtained without being asked for a bribe, as is the case at most banks. \$1,000 was used for crop inputs and the balance to purchase sheep. With repayment based on cash flow, an interest payment of \$248 was made in July. Principal of \$2,348 will be repaid in August from sale of wheat seed and subsequent payments will be made in September and October. Repayments were determined based on an agreed business plan, which set out a projected cash flow. Allowing payments according to cash flow permits the wheat seed to be held longer for a better price rather than placing it on the market immediately. Last year, prices peaked at the equivalent of \$250 per ton and presently they are at \$129. There is more than adequate wheat inventory to liquidate the loan.

This client looks toward repaying the loan and using more credit in the future. Among the improvements he would like to finance in the future are:

- Equipment for seed cleaning---as the cleaner he has now is very rudimentary. A cleaner would allow him to sell a better seed product and sell feed screenings for livestock and poultry.
- Better equip a workshop for combine and tractor repairs. He would like to stock some common combine parts as currently the closest source is 120 Km away. He believes \$5,000 would be sufficient for this.
- A new combine, which he would actually prefer to lease rather than purchase outright.

APPENDIX A

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APPENDIX B

BORROWERS INTERVIEWED

SUMMER, 2001

Baku

Name: Sabir Khydurov
Business: Gormet/Trousers
Lender: World Vision

Name: Hidayat Askerov
Business: Commercial Print Shop
Lender: IFC/AzeriGazBank

Business Name: L.E. Khazry
Business: Grocery Store
Lender: SOA

Name: Zaur Sadigov
Business: Food Shop/Mini-vans
Lender: World Vision

Name: Amir Mammadov
Business: Leather /Sewing
Lender: World Vision

Name: Tahir Novruzov
Business: Retail/clothing for women
Lender: FINCA

Business Name: DIASIS
Representative: Natig Sadigov
Business: Medicine/Laboratory work
Lender: IRC/RabitaBank

Name: Fazil
Business: Cosmetic/Perfumes, lotions
Lender: FINCA

Barda

Name: Nazila Basti
Business: Women's Cloths
Lender: Save the Children

Name: Rahbar Iskenderov
Business: Vegetable crops
Lender: Save the Children

Name: Parvin
Business: Leather processing & sewing
Lender: OXFAM

Name: Kapaz Israel
Business: Market/Mensware
Lender: Save the Children

Name: Hafiz
Business: Leather processing
Lender: IRC

Name: Dostlug
Business: Sheep feeding & trading
Lender: OXFAM

Name: Bara Shambulag
Business: Used auto parts
Lender: IRC

Name: Naila Girgiz
Business: Retailer/ Grocery Store
Lender: IRC

Jalilabad

Name: Agayev Mirza
Business: Wheat seed, sheep
Location: Sharabkhanli Village
Lender: CredAgro

Name: Hasanov Alekper
Business: Fattening steers
Location: Babakhanli Village
Lender: CredAgro

Name: Suleymanov Faig
Business: Fattening steers
Location: Babakhanli Village
Lender: CredAgro

Nakchivan

Name: Sadigov Maftun
Business: Market/Trade
Lender: ADRA

Name: Orudjov Elchin
Business: Market/Trade
Lender: ADRA

Name: Mammadov Tofiq
Business: Sheep, goats & turkeys
Lender: ADRA

Name: Seidov Yusif
Representative: Rabitabank Branch Manager
Business: Banking

APPENDIX C

AZERBAIJAN CREDIT EVALUATION QUESTIONNAIRE

By

**Peter Fraser
Ronald Bielen
Marshall Burkes**

Representing

**Development Associates (Prime)
Nathan Associates**

August 13, 2001

This Regional Credit Evaluation was initiated and funded by USAID

1. Please identify specific major constraints to increased credit access in Azerbaijan and suggest corrective measures for those constraints.		
Item	A: Major Constraints NOW	B: Corrective Measures NEEDED
Legal		
National Regulatory		
Local Regulatory		
Operational (within institution)		
Operational (outside institution)		
Source of Funds		
Stability of National Monetary System		
Stability of National Investment Climate		
Other (specify)		

2.1 Demand for Credit Exceeds Supply by % (For each of the loan types please mark the percentage by which you believe credit demand exceeds present supply. If you believe there is not a short supply of a certain loan type, please mark the ' 0% ' column for that loan type.)					
	0%	25%	50%	75%	≥100%
Non-Bank Category					
Loans					
< \$1,000 (USD) (micro)					
\$1,000 - 5,000 (transition)					
\$5,000 – 10,000 (transition)					
> \$10,000 (small)					
Pawn Shop Loans					
- Gold					
- Non- gold					
Vendor Credits					
- From Vendors					
- From Others					
Rotating Savings and Credit Assoc. (Latarea)					
Family and friends					
Other Loans					
(specify _____)					
Agricultural Loans					
_____ Type Loans					
Other Production Loans					
(specify _____)					
Other Agricultural Loans					
(specify _____)					
Other					
Residential Improvement Loans					
Financial Advisory Services					
Grant /Loan Type					
Government Credits					
- National					
- International					

2.2 Demand for Credit Exceeds Supply by % (For each of the loan types please mark the percentage by which you believe credit demand exceeds present supply. If you believe there is not a short supply of a certain loan type, please mark the ' 0% ' column for that loan type.)

	0%	25%	50%	75%	≥100%
Bank Category					
Short Term					
Consumer Loans					
Asset Loans					
Commodity Loans					
Working Capital Loans					
Loans Line of Credit (overdraft)					
Pawnbroker Loans					
- Gold					
- Non-gold					
Other					
(specify _____)					
Longer Term					
Real Estate Loans					
Land Loans					
Home Improvement					
Leasing					
Agricultural Loans					
Other Loans					
(specify _____)					
Other					
Financial Advisory Services					
Other					
(specify _____)					

2.3 Demand for Credit Exceeds Supply for possible USAID assisted products by % (For each of the following financial products please mark the percentage by which you believe credit demand exceeds present supply. If you believe there is not a short supply of a certain product, please mark the ' 0% ' column for that loan type.)					
	0%	25%	50%	75%	≥100
Possible USAID Assisted Products					
Equipment Loans					
Equipment Leasing					
Real Estate Purchase					
Building Improvement					
- Residential					
- Commercial					
Leasehold Improvements					
Land Purchase					
Lease Purchase					
Production Loans					
Business Loans					
Loan Products:					
- Targeted to Women					
- Targeted to Men					
Other Products - Loan /Non-loan					
(specify_____)					
(specify_____)					
(specify_____)					
(specify_____)					
(specify_____)					

Table 3.1: Issues Related to Strengths and Weaknesses of USAID-funded Non-Bank Credit Institutions

(Please comment on your institution and any others you may wish to include)

Topic	<i>Your Institution</i>	Other Institution (Name:_____)	Other Institution (Name:_____)
Sustainability:			
<i>Strengths</i>			
<i>Weaknesses</i>			
Governance:			
<i>Strengths</i>			
<i>Weaknesses</i>			
Internal Controls:			
<i>Strengths</i>			
<i>Weaknesses</i>			
Products:			
<i>Strengths</i>			
<i>Weaknesses</i>			
Market Position:			
<i>Strengths</i>			
<i>Weaknesses</i>			
Other:			
<i>Strengths</i>			
<i>Weaknesses</i>			

Table 3.2: Issues Related to Opportunities and Threats facing USAID-funded Non-Bank Credit Institutions (Please comment on your institution and any others you may wish to include)

Topic	<i>Your Institution</i>	Other Institution (Name:_____)	Other Institution (Name:_____)
Sustainability: <i>Opportunities</i>			
<i>Threats</i>			
Governance: <i>Opportunities</i>			
<i>Threats</i>			
Internal Controls: <i>Opportunities</i>			
<i>Threats</i>			
Products: <i>Opportunities</i>			
<i>Threats</i>			
Market Position: <i>Opportunities</i>			
<i>Threats</i>			
Other: <i>Opportunities</i>			
<i>Threats</i>			

Table 4.0: Institutional sustainability of USAID-financed microfinance projects.

PLEASE RATE EACH ACCORDING TO THE FOLLOWING CATEGORIES:	INADEQUATE	ADEQUATE	MORE THAN ADEQUATE
Operational Sustainability: Current _____%			
a. Management Issues:			
Transition from T/A to local			
Management succession			
Independence of local management From local pressures			
Adequacy of compensation of local managers			
b. Personnel Issues			
Training			
Organizational structure			
c. Checks and Balances			
Policies			
Procedures			
Internal controls			
d. Market Issues			
Pricing of products			
Size of market			
Expansion of products and geographic areas			
<i>Financial Sustainability: Current _____%</i> <i>(Note: In addition to operating sustainability issues, the following are necessary)</i>			
a. Original funding			
b. Uninterrupted on-going funding			
c. Diversification of funding sources			

4.1: What is your institution's current level of sustainability?

4.2	What level of sustainability do you expect	for each year?
	Operational	Financial
	Oct. 1/01 - Sept. 30/02 _____%	_____%
	Oct.1/ 02 – Sept. 30/03 _____%	_____%
	Oct. 1/03 – Sept. 30/04 _____%	_____%

4. 3. What specific actions are planned to achieve & maintain sustainability?

APPENDIX D

SCOPE OF WORK

FOR REGIONAL CREDIT EVALUATION IN GEORGIA AND

AZERBAIJAN

USAID/CAUCASUS

SUMMARY

This comprehensive evaluation will review, analyze, and evaluate the current status in the development of financial products and credit provided by banking and non-banking financial institutions (NBFIs) in Georgia and Azerbaijan in the context of overall credit demand-supply. Based on the findings, the evaluation team will make specific strategic and programmatic recommendations for USAID's ongoing assistance.

BACKGROUND

Lack of access to credit has been identified by USAID and other donors as one of the major impediments to growth of micro-and-small enterprises (MSE) in Georgia and Azerbaijan. As a result, increased access to finance for domestic enterprises and microentrepreneurs is a key Intermediate Result under USAID/Caucasus/Georgia's Strategic Objective (SO) 1.3, "Accelerated Development and Growth of Private Enterprise". It is also a critical component of SO 3.1, "Reduced Human Suffering in Targeted Communities", providing income generation opportunities for the more vulnerable population. These two Strategic Objectives also apply to the Azerbaijan program.

USAID provides access to finance for domestic SMEs and micro-enterprises. In Georgia SO 1.3 activities currently are implemented by FINCA International, Shorebank Advisory Services, ACDI/VOCA, and Save the Children/Constanta. In Azerbaijan implementors include FINCA International, Shorebank Advisory Services, and ACDI/VOCA. Credit activities funded under SO 3.1 in Georgia and Azerbaijan include those implemented by International Rescue Committee (IRC), Mercy Corps International, and Adventists Development and Relief Agency (ADRA), CARE, and UMCOR.

While both economic development and humanitarian assistance portfolios include credit activities, the focus and operating practices are not the same. Humanitarian Assistance (HA) credit operations are relatively short-term and do not focus on institution building, so are not consistent with microfinance "best practices". As micro-small-and medium enterprise (MSME) activities expand and increase demand on credit providers, it is important to determine how to create stable and sustainable credit facilities.

Other donors have begun an increasing variety of credit facilities in both countries since 1997. For Georgia, such examples include International Financial Corporation's (IFC) credit lines for

SME lending through Georgian commercial banks, French Government funding for establishment of 90 credit unions, and World Bank (WB) funding for the establishment of 120 credit unions. In Azerbaijan IBRD, IFC, and GTZ also assist in providing increased access to credit to SMEs.

As a result of increased donor assistance in the credit sector, credit programs have expanded geographically and, at the same time, have embraced more and diverse target groups such as farmers, agribusiness, production and service, self-employed micro-entrepreneurs, internally displaced people (IDPs), women, and other vulnerable groups. Sufficient effort has been placed on strengthening or building the institutional capacity of credit providers in Georgia and Azerbaijan. As a result, there has been a significant number of failures including the WB credit unions in Georgia, the majority of which failed within 12 months of start-up. The assumption is that there is the need for capacity building to increase sustainability of credit institutions in both countries. The evaluation is expected to test/validate this assumption.

Bank credits for SMSEs have increased somewhat over the last few years, as has technical assistance to banks provided by donors and international organizations.

Overall progress in the development of credit facilities during the past three years in Georgia is characterized by: establishment and growth of microfinance institutions (MFIs); growth in the variety of MSME lending products; up-scaling of credit products to larger amounts; a growing coalition between banks and NBFIs; emergence of MFI joint efforts to address legal-regulatory issues; and graduation of clients from group to individual lending.

For Azerbaijan the progress observed is less distinct. This is due in large measure to legal-regulatory barriers that constrain the development of micro-and small-enterprises. USAID's involvement in initiating legal-regulatory reform has been limited by provisions of Section 907 of Freedom Support Act (FSA). Further, legal constraints have created serious problems for functioning of non-banking financial institutions. Such legal issues caused FINCA to suspend operations for almost nine month in 1999 almost leading to total closeout of its operations. (The issue was finally resolved by obtaining a limited Banking License under which FINCA operates todate.)

While Georgia has fewer barriers, it also does not have a micro-enterprise development policy. Furthermore, many legal and regulatory barriers remain that constrain the development of micro-and small-enterprises. It is estimated that 55% of economically active Georgians are self-employed microentrepreneurs. Given this fact, the fostering of micro-enterprise development is an important aspect of economic development, as well as an important poverty reduction strategy.

OBJECTIVES AND TASKS

The principal objective of this evaluation is to examine the development of access to credit in Georgia and Azerbaijan in a broad and comprehensive manner. The evaluation should identify major constraints and opportunities plus provide specific recommendations for USAID's further capital funding or technical assistance in this area.

In Georgia the evaluation will focus on:

- Analysis of major constraints (legal, regulatory, operational, financial, etc.) for increased access to credit in the country. Analysis should include deficiencies in infrastructure elements.
- Analysis of demand and supply of credit including identification of the products and services in highest demand, as well as the most successful form(s)/structure(s) of credit institutions (banking and non-banking). Analysis should include identification of target groups that have been most efficiently reached by financial products, as well as those that have not been reached yet, and reasons for this. This should also include analysis of the number and characteristics of the current and potential clientele.
- Analysis of financial products supplied by banks and NBFIs in context of existing demand, and potential for new products and/or expansion of existing supply. Examples include, but are not limited to, micro-leasing and residential improvement loans.
- An overview of USAID-funded credit institutions serving micro-and small entrepreneurs, their strength, weaknesses, threats and opportunities. This should include analysis of issues relevant to sustainability, governance, internal controls, products, market position, etc.
- Analysis of financial and operational sustainability issues of established MFIs. What are the prospects for sustainability and what can be done to ensure future sustainability.
- Analysis of current status and potential for affiliation/partnership between banking and non-banking institutions, such as potential lending to MFI from banks, funding facilities, portfolio investments, etc.
- Design characteristics and profile of credit operations under SO 3.1 portfolio that can serve as parameters for potential rationalizing/transitioning into more developed operations.

In Azerbaijan the evaluation will focus on:

- Analysis of major constraints (legal, regulatory, operational, financial, etc.) for increased access to credit in the country. Analysis should include deficiencies in infrastructure elements.
- Analysis of demand and supply of credit in country including identification of the products and services in highest demand, as well as the most successful form(s)/structure(s) of credit institutions (banking and non-banking). Analysis should include identification of target groups that have been most efficiently reached by financial products, as well as those that have not been reached yet, and reasons for this. This should also include analysis of the number and characteristics of the current and potential clientele.

- Analysis of financial products supplied by banks and NBFIs in context of existing demand, and potential for new products and/or expansion of existing supply. Examples include, but are not limited to, micro-leasing and residential improvement loans.
- Analysis of financial and operational sustainability issues of established MFIs. What are the prospects for sustainability and what can be done to ensure future sustainability.
- An overview of USAID-funded credit institutions serving micro-and small entrepreneurs, their strength, weaknesses, threats and opportunities. This should include analysis of issues relevant to sustainability, governance, internal controls, products, market position, etc.
- A comparison between the SO 1.3 and SO 3.1 portfolio, in order to determine where better and more strategic complementarity is possible in the future, given the current status of economic development in Azerbaijan.

DELIVERABLES

The evaluation will have two sets of deliverables: one for Georgia and another for Azerbaijan.

❖ Georgia

The team will submit a work plan within two days after arrival in Georgia.

At the completion of the evaluation Georgia, the team will brief the Mission staff, and will submit a draft report that will summarize all tasks outlined in this Scope of Work. The report will also include findings and recommendations on priorities for further assistance/activities in the area. The report should include recommendations on best ways to ensure the most efficient delivery of credit, on future assistance to banking and non-banking institutions, on the ways of rationalizing/addressing sustainability issues vis-a-vis the credit programs currently operating under SO 3.1. Based on the findings the evaluation report will also make specific strategic and programmatic recommendations for USAID's further assistance in this sector.

The draft will be presented to USAID/Georgia before the team departs. The Mission will provide comments and suggestions within one week of receiving the draft. The Final Report (in amount of 10 bound copies and an electronic version in PDF format) will be provided to the Mission within two weeks after completion of evaluation Georgia.

❖ Azerbaijan

The team will submit a work plan within two days after arrival in Azerbaijan.

At the completion of the activity, the team will brief the USAID/Baku Mission staff, and submit a draft evaluation report that will summarize all tasks outlined in this Scope of Work. The report will also include findings and recommendations on priorities for further assistance/activities in the area. The report should include recommendations on best ways to ensure the most efficient delivery of credit, on future assistance to banking and non-banking institutions, on the ways of

rationalizing/addressing sustainability issues vis-à-vis the credit programs currently operating under SO 3.1. Based on the findings the evaluation report will also make specific strategic and programmatic recommendations for USAID's further potential assistance in this sector.

The draft will be presented to USAID/Baku before the team departs. The Mission will provide comments and suggestions within one week of receiving the draft. The Final Report (in amount of 10 bound copies and an electronic version in PDF format) will be provided to the Mission within two weeks after completion of evaluation Azerbaijan.

LOGISTICAL ASSISTANCE

The Mission will provide background and reading materials. The Mission will provide logistical support in scheduling meetings and site visits. The Contractor is required to provide all other logistical support, such as travel, accommodation requirements, etc.

Evaluation team members are requested to bring laptop computers with them.
The team is responsible for hiring local interpreters and local driver(s) with a vehicle(s).

DOCUMENTS FOR REVIEW

For Georgia:

“Capital Products Survey” by Sibley International, 2000.

“MFI Legislation in Georgia” by FINCA/Georgia, 2000.

Last Quarterly and Annual reports of Shorebank/FINCA, ACDI/VOCA, and Save the Children/Constanta.

Report of some Humanitarian Assistance credit projects: IRC, ADRA, UMCOR.

Banking Sector Assessment, Barents Group, 1998.

Private Sector Assessment by DAI and Price Waterhouse, 1999

Trip Report of March 2001 by Laurie Landy, AID/Washington E&E Senior Banking Advisor

Microfinance Legislation in Georgia, May, 2001, by FINCA/Save

For Azerbaijan:

Private Sector Assessment, Price Waterhouse Coopers, 2000.

Rule of Law Assessment, by USAID/Washington, 2000.

Economic Trends, Winter 2001 Quarterly Report, EU/TACIS

Last Quarterly and Annual reports of Shorebank/FINCA, and ACDI/VOCA

Report of some Humanitarian Assistance credit projects: IRC, ADRA, Mercy Corps

APPENDIX E

LIST OF REPORTS AND PUBLICATIONS

Capital Products Survey: Survey Results (Revised Edition), Colette McInerney, December 15, 2000.

The Caucasus SME Finance Program (CSFP) Quarterly Report – March 2001: Shorebank Advisory Services, April 30, 2001.

Seed Enterprise Enhancement and Development (SEED) Project: (USAID – ACDI/VOCA Cooperative Agreement № NIS-A-00-97-00046-00), Second Quarter FY 2001 (Yr. 4).

Strategic Plan Azerbaijan: FY 2000- FY 2003, USAID/Caucasus, June 1999.

Annual Reports and Brochures

ACDI/VOCA

FINCA

Microfinance Bank of Georgia: Annual Report 2000 and 2001.

World Vision Azerbaijan

Save the Children

Mercy Corps, Economic Opportunities Bulletin /August 2001 Volume I No.18

Economic Trends, Quarterly Issue/Azerbaijan/ January-March 2001

Fourth Quarterly Narrative Report for Quarter ending, March 2001, CIDA Project No.QS/Z020147

Bank's Association Azerbaijan/Azerbaijan Bank's Systems Report /2000.